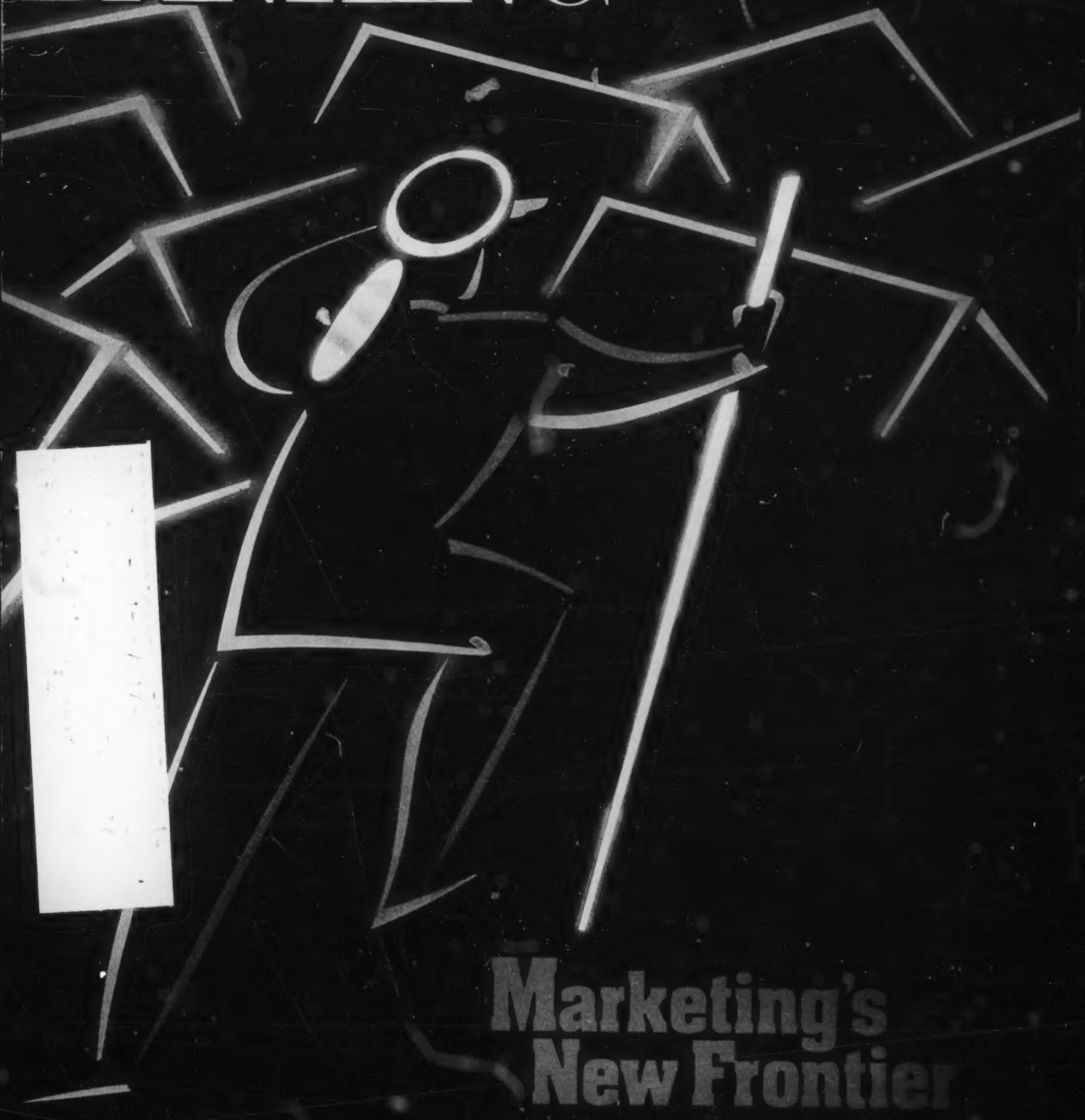
NOVEMBER 1990

MORTGAGE BANKING

THE MAGAZINE
OF REAL ESTATE
FINANCE



Marketing's New Frontier

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Marketing

Mortgage lenders are fishing in new waters for business. The days of relying solely on Realtors and builders for mortgage business are history. Some pioneers in the industry are linking up with large corporations and membership groups as preferred providers of mortgages to employees and members. In many ways, marketing in the mortgage business is venturing into previously uncharted territory.

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COVER ILLUSTRATION BY STEVE McCRACKEN

Pioneering Spirits

Mortgage bankers have never been that adventurous in pursuing marketing efforts. Advertising long remained an unexplored enterprise for the typical mortgage company. In the past, and even today, most mortgage bankers have relied on a crew of proven loan salespeople who forge loyal relationships with Realtors to bring in business. But now some of that appears to be changing. Our cover article examines a new way to bring in mortgage business that does not rely on loan officers or Realtors. The strategy hinges on marketing your loan programs and origination servicers to large corporations and membership groups. This push to corner large accounts outside of the realm of the builder/Realtor is one of the new avenues of the modern production manager. Dedicated, small squads of specialists have been given the mission of growing this source of originations. Companies such as IMCO Realty Services, Inc., First Union Mortgage Corporation and PHH US Mortgage Corporation have been pursuing this niche successfully. But it requires an operation that can consistently deliver top service—a tough job.

This issue also explores why investors and borrowers are so hot on the new five- and seven-year balloon mortgage products. These mortgages built for mobility are a tribute to the secondary market's ability to strike a balance between the needs of today's borrowers and investors. In about a year's time, Fannie Mae has managed to securitize roughly $3.8 billion worth of its seven-year balloons.

Finally, in the big promises department, this month's issue carries a story about Soviet President Gorbachev's ambitious goals for spreading homeownership in his country. The Soviet leader publicly announced a goal of having every family owning an apartment or house by the year 2000. To make good on this promise, the Soviets would have to build 30 million apartments and houses at a minimum of 6.56 billion square feet. The skeptics are already closing in on this one.

Janet Reilley Hewitt
Editor in Chief

COMING IN DECEMBER

How people are paid in the mortgage banking business is the topic for December's issue. We look at the results of a national survey of compensation trends in the industry.

MORTGAGE BANKING
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TECHNOLOGY CROSSROADS

Investing in an automated system is an overwhelming decision. Here are some tips just for starters.

Brian Hershkowitz

Although that proverbial day when "computers will take over our jobs" is not here yet, advancing technology has changed the way mortgage lenders think about their company's operations. While reducing manpower in order to cut costs may appeal to the bottom-line sensibilities of mortgage banking managers, the dive into automation can mean more than that—by breathing new life into a company's vital signs.

Statistics such as the amount of loans serviced per servicing employee, loans produced per operations personnel and loans underwritten per month are some of the telling report cards of automation. If we can increase the capability of current staff—to produce more and service efficiently— we can use this capability to make and service more loans. Technology can also put mortgage bankers in a growth position by allowing them to do more of what they do best, at the least possible cost.

Many mortgage bankers sit on the brink of a difficult decision today—that is, whether or not to invest in the automation of their company's operations. What factors can they consider to ease the challenge of the technology decision? This article maps out six different areas for analysis: technological assessment, cost-to-acquire, implementation, upgradeability, system fit and long-term gain. Examining these areas will assist managers in their pursuit of the proper degree of automation for their organization.

The technology assessment

Decisions to acquire automated systems are based on a technology assessment—a complete examination to determine which areas of the company can most benefit from technology. Performing this type of analysis is important; it enables the company to end up with a product that supplies the functions the firm needs at the right level of capacity. The three factors that should be assessed are the company's needs, goals and available technologies.

Realizing the need to automate is a fundamental step. Lenders should ask: "What efficiencies can be obtained by adding technology to the current paper flow? What, if anything, needs to be done now? What new needs will the addition of the system create?" To clearly understand these kinds of questions, management must zero-in on the current strengths and weaknesses of the operation.

Jeffrey Butler, senior vice president and chief information officer at Countrywide Funding Corporation, Pasadena, speaks strongly of examining his company's needs at this early stage. "When we talked about our commitment to technology, we decided to start our automation efforts before the technologies were even commonplace." Countrywide saw its major investment in technology as a way to confront the ultimate operational issue—better customer service. Thus, by evaluating the needs and capabilities of different parts of their organization, Countrywide has taken a leadership position because their assessment was not based on what vendors had to offer—rather, it was shaped by the goals of top management at the firm.

When a company's management believes that its operations are not at peak efficiency, it is because they perceive that some processes could work differently. Maybe the current system lacks a tracking component. Or, two separate systems may not interface well. Perhaps volume of the corporation is overwhelming the existing personnel and equipment. In each case, management must spell out their perception of a better system in terms of goals and specific tasks. Once the needs have been assessed, vendors can be solicited to offer various systems. Each vendor may come up with a completely different idea; therefore, it is wise for the manager to keep clearly in mind what steps the company is willing to take.

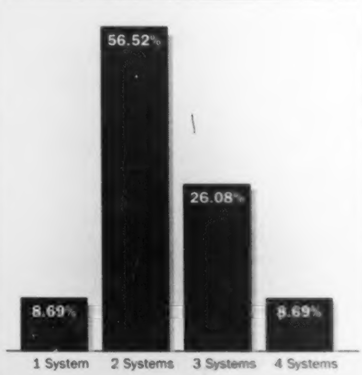
First, managers at many levels of the company should be called in to discuss which areas can truly benefit from automation. Not only will interesting information be passed upwards with regards to line operations, but this should encourage many employees to be receptive to the events to come. By believing that their input has helped shape the system, the company's staff may contribute more willingly when asked to help get the system off the ground.

It is also important that part of the technological assessment involves looking at the competition's investment in technology. If it is management's primary goal to keep ahead of their competitors, then those in the acquisition process must keep that in mind. A company's use of technology often distinguishes it as a market leader.

Also, many vendors have user groups that are open to those who are considering the purchase of a system. By having a staff representative visit one or two of these meetings, you may learn about unique opportunities for your firm, as well as deficiencies that other users have had with a particular system.

TABLE 1

How many different systems do full service mortgage bankers utilize?



Availability

In the world of information processing, three alternatives are available for the utilization of software for a particular function. The first choice is to use prepackaged software programs, written generically for many people who want to automate the same function. This "off-the-shelf" type of product bears the lowest initial cost. The second choice is to hire a programmer and systems analysis staff to build in exactly the features you want. This produces a customized rendition of an automated function. The third choice is a hybrid, and involves finding an off-the-shelf product that can be customized to some of your specifications. There are great differences in cost, security and usage timeframes for these three possibilities.

A company's use of technology often distinguishes it as a market leader.

In a recent survey of mortgage bankers by the Mortgage Bankers Association of America (MBA), 100 percent of the respondents reported that at least one of their automated systems was developed completely in-house. These systems were most often in the area of internal management, and were designed to interpret and report data supplied by other systems that served production or servicing. To integrate the various systems, therefore, it may be necessary to have at least one fully customized application.

Within the realm of customized technology almost anything can be made available, given enough time and money. At the assessment stage, information managers should evaluate what the company needs and which systems could satisfy them. Jeffrey Butler pointed out that, at the time Countrywide made a commitment to optical image processing, the technology was not widely available or proven. They made it work, however, because of the forecasting and planning done in the assessment stage.

Most automated systems are available on stand-alone personal computers, networks, minicomputers and mainframes. While not delving into the technical details of particular computers, it is true that the more processing capacity a company may be trying to buy, the higher the cost.

Vendors will often help a company with its technological assessment. A tool called a design document can supply not only technical specifications but also reporting and tracking data. The design document, while not a plan for final installation, will propose an implementable alternative. Management can split the document into parts and introduce its processes to those managers who will be affected. If the information flow or format will not meet the needs or desires of the firm, then other alternatives should be found. For instance, if a company produces a design document showing a flow of data from origination to servicing that involves sending the data to an outside firm for conversion, this process is unlikely to meet the need of a company that desired greater accuracy in the information flow.

A key to the success of the vendor's design document is the specificity of the company's requirements. Assuming that the system is technically feasible and has available resources, the only real limitation on today's software providers is the manager's ability to spell out what he or she wants. Vendors should be encouraged to meet with a group of the company's veteran managers to ensure this vital two-way communication takes place.

Cost-to-acquire

Any analysis must begin with the price tag attached to the proposed system. Jeff Lebowitz, president of Strategic Systems Partners, a Washington, D.C. research firm, points out that, "mortgage banking as an industry is most likely to make technology decisions when they are in regard to saving costs." Technology does not come cheaply, and companies are wise to analyze how long it will take them to break-even on their investment. Therefore, dollar values should be assigned to expected efficiencies that will result from automation.

Lowered expenses can come from many sources. Better utilization of personnel, centralization of processes, improved marketing decisions (accurate information and pipeline histories can certainly benefit the secondary marketing), quicker delivery time and an increase in loans-per-servicing employee are just a few examples that can be quantified. Often the dollar value of an error, whether it be from uninsurable loans, lack of coverage in a falling market, or the necessity of hiring temporary staff in critical periods, can be ascertained by management. Thus, the amount the company is willing to spend can be reasonably related to expected gains and the avoidance of losses that will come from the technology.

Once you estimate how much you will save per month (or perhaps how much additional income from added business you can obtain), you have the necessary figures to determine the break-even period. To do this, divide the benefit-per-month into the total cost of the system, and you are left with the amount of months before the system's efficiencies have made the purchase cost-effective. In a highly competitive industry such as mortgage banking, stretching the break-even period over 18 to 24 months would be reasonable. Al Brown, senior vice president of Charlotte, North Carolina-based First Union Mortgage Corporation, says that at his company, "internally, 18 months is used as a threshold for decision-making." Brown also pointed out that this figure can vary greatly at different firms depending on their strategic plans.

Whether it is a shorter or longer timeframe, however, the analyst must keep in mind that automation will eventually spawn a competitive advantage. This advantage may be in goodwill, enhanced customer relationships and/or a better market reputation. Factoring into this cost-to-acquire analysis, then, is the fact that investing in a new system will rarely lead to enhanced profitability overnight—because the company will reap its rewards over the long term. In fact, the six-month period following the product acquisition may be fraught with great expense.

H. Marc Helm, executive vice president of Barron Financial Group, Tustin, California, and chairman of the MBA's Technology Task Force advises that, "Managers must consider return on investment when making decisions to acquire. However they must also apply both subjective and objective means of analysis when considering technology. The long-term effects on customer service, industry reputation and other efficiencies must enter into the decision-making process."

Implementation

Factors involving implementation include the retraining of personnel, the customization of any of the technology to the firm's needs and the development of the culture that is necessary for the new system. These factors can take a toll on the mortgage banking operation's resources.

Sears Mortgage Corporation, Riverwoods, Illinois, a leader in the use of automation for the entire loan production process, uses an implementation team, Dennis Gingue, senior vice president in charge of information technology explains.

"To get people to be competent and proficient quickly, they needed to be trained [off the site of] the branch office environment. While the operations staff is being trained away from ringing phones and the demands of the loan officers and clients, [Sears] sends an implementation team to the branch. The team then certifies that the equipment has been installed properly and

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converts the existing pipeline. In this fashion, the trained staff returns, ready to work," he said.

Though the cost of this approach is likely to be high, it is designed to add speed to the training equation. Thus, many costs may be recouped by lack of down-time and positive customer satisfaction.

Retraining personnel is a primary concern of those integrating any type of new system. Though a company's staff may be computer literate, using a specific software package or a new type of hardware requires a certain amount of rethinking. New users must learn about what types of information they need to have on-hand when they wish to perform a task. They must be trained in the way in which the system accepts information. The order in which tasks are performed must also be reconsidered. Those who have not had any formal computer background may need training in keyboard skills. Whether the question is technical or procedural, it will take a company a certain amount of time to get everyone up and running.

A company's culture can change when the corporation becomes driven by management information systems (MIS). When MIS is viewed by all in a company from the line worker to top management as a new type of accountability and performance analysis, a firm has truly integrated their new technology.

As part of the implementation phase, managers must be encouraged to comment on the procedures, systems and products that have been installed. Users can be encouraged to form groups that propose innovative suggestions. If corporate culture allows for this type of development, MIS becomes an excellent tool.

System fit

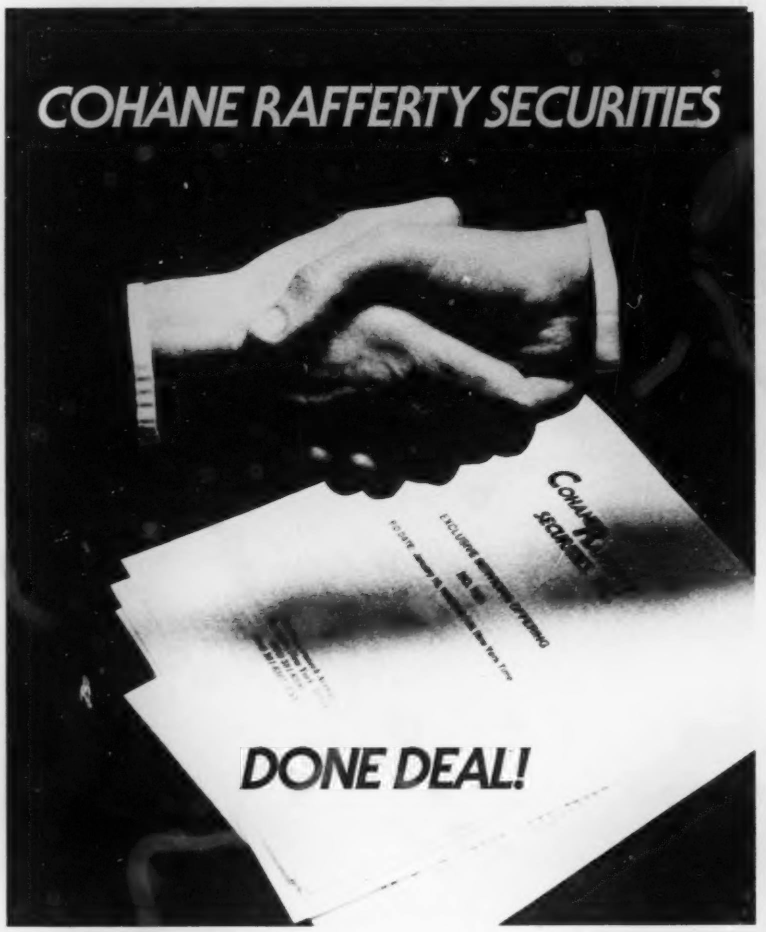
A good "fit" between the type of system a company is acquiring and the functions it will be used for is critical. While loan processors may use word processing software, most word processors will not apply to other needs, such as tracking or truth-in-lending computation. If only some employees in the firm will be using the system that is being acquired, the company must also consider how their work will be integrated with other systems. Will there be an interface to link either another automated system or a manual system with the new technology?

Certain types of technology are considered "free-form." Data can be stored in a variety of ways, and output (reports or forms) can be structured to the company's preference. Other systems only allow details to be entered in a certain way, at a certain time, or only have their output printed in a particular format.

Many firms desire to maintain a paper trail on all transactions. Some products may ensure a better fit between manual tracking with an automated process. One example might be when data is input with a corresponding document number that can be filed for later reference.

Upward compatibility

A key element involved in the decision to incorporate new technology is having an overall plan that sees far into the future. Firms that bought small, stand-alone, task-specific systems in the 1980s can now vouch that it is hard to integrate these units into an overall



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system. Equipment and software acquired today must be useful for tomorrow's tasks and growth opportunities.

Some firms may choose to explore upward compatibility by buying a machine that has a larger capacity than is necessary for the company's current operations. While this makes sense as part of a strategy, it is equally important to have software that is flexible in its ability to receive and deliver processed information. Connectivity—sharing data between the organization's computers—and data standards—the manner in which information is passed on—are keys for future expandability.

Connectivity and data standards are currently under development in the industry. In the same vein as the development of a Uniform Residential Appraisal Report (URAR) or the soon to be released Uniform Residential Loan Application (URLA), computers can present vast amounts of similar data in an organized manner. One of the biggest pluses about the way in which a computer can perform the task is that it does it without a lot of bookkeeping or labor-intensive research.

Mortgage bankers have been able to limit the number of different systems that are necessary for growth. As you can see from Table 1, the vast majority of respondents to the survey have three-or-less unique systems operating. Over time, this may be of great benefit because developing interfaces between varied systems can be a difficult task.

Long-term gains

There are many direct long-term gains from automation. Companies that integrate different systems may end up with loan production data that can be passed directly on to their servicing system. These systems do more than cut data-entry expense, they can reduce the number of times such a mistake can be made—which is likely to enhance the bottom line for the mortgage banking operation. For instance, by using data that has been input only once by the loan officer to establish the electronic servicing file, the opportunity for a later mistake from others who handle the file is dramatically reduced.

By using a combination of systems, such as optical storage and bar coding with origination and servicing systems, mortgage bankers can drastically reduce costs. This results from reduced search and filing time, less paper storage, and higher rates of data accuracy. If a growing firm has the systems in place to expand, it may consider becoming a full service mortgage banking company, or offering complimentary lines.

In a recent survey of participants at the 1990 MBA President's Conference, it was noted that close to 60 percent had a chief technology officer. Mortgage bankers are aware of the importance of technology and its impact on their companies. Many are dedicating substantial resources to studying and making the technology decision. With a plan of action for what the future may hold, mortgage bankers will be well equipped to perform the various assessments needed to make the critical technology decision. **MB**

Brian Hershkowitz is an associate director of government agency relations for the Mortgage Bankers Association of America in Washington, D.C.

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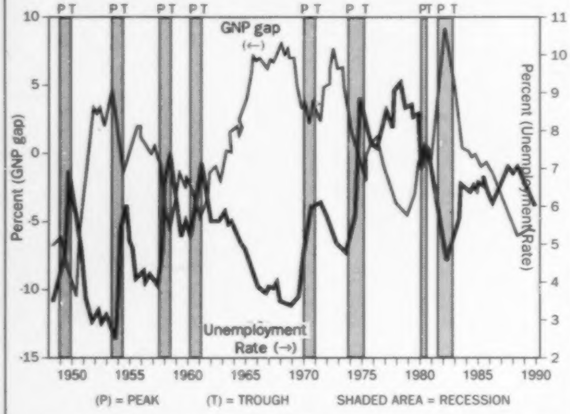
ECONOMIC TRENDS

Recession. After over 7½ years of economic expansion—the longest peacetime expansion since World War II—the U.S. economy appears on the brink of a recession, if it has not already tipped into one. What exactly constitutes a recession? How severe are they typically? How long do they last? Is this one likely to be more or less severe than most?

To begin with, the definition of a recession is not clear-cut. Newspaper stories frequently declare that a recession is defined as two consecutive quarterly declines in real gross national product (GNP). This is the popular definition, but it is not the one economists typically use. Recessions are periods of the business cycle during which economic activity declines. GNP is one important gauge considered in judging the extent of economic weakness, but it is not the only one. The official beginning of a recession and the end are designated by the National Bureau of Economic Research (NBER)—a private research organization in New York—based on an analysis of many statistical indicators, including GNP, unemployment, employment growth, industrial production and many others.

CHART 1. Post-World War II Recessions



Note: The GNP gap is actual constant-dollar GNP minus its long-term trend value, as a percentage of its long-term trend value. In effect, the measure shows how much actual GNP differs from its long-term trend in percentage terms.

TABLE 1

Post-World War II Recessions

Peak Quarter (Month)	Trough Quarter (Month)	Recession Duration: Number of Quarters	Recession Duration: Number of Months	Peak-to Trough Change in the Unemployment Rate (Percentage Points)	Peak-to-Trough Change in Real GNP (Percent)
1948:4 (November)	1949:4 (October)	4	11	+4.1	−2.0
1953:2 (July)	1954:2 (May)	4	10	+3.3	−3.0
1957:3 (August)	1958:2 (April)	3	8	+3.3	−3.0
1960:2 (April)	1961:1 (February)	3	10	+1.7	+0.3
1969:4 (December)	1970:4 (November)	4	11	+2.4	−0.4
1973:4 (November)	1975:1 (March)	5	16	+3.8	−4.3
1980:1 (January)	1980:3 (July)	2	6	+1.5	−2.3
1981:3 (July)	1982:4 (November)	5	16	+3.6	−3.2
Average:—	—	3.8	11.0	+3.0	−2.2

Chart 1 and Table 1 show selected characteristics of post-World War II recessions. There have been eight. NBER designates both the peak month (and quarter) immediately preceding each recession, where the business cycle is at its high point, and the trough month (and quarter) signifying the end of a recession, where the business cycle is at its low point. Immediately following the peak through the trough is the recession per se.

As Chart 1 illustrates, the unemployment rate soars during recessions. It then declines during the expansions following recessions, with particularly sharp drops in the first few quarters after the recession. The chart also shows that GNP declines or grows extremely slowly during recessions. However, a review of GNP growth during recessions reveals the pitfalls of defining a recession as two consecutive quarters of decline in GNP. Neither the 1960–1961 recession, nor the 1980 recession showed two successive quarterly declines; yet there is little doubt from other indicators that the economy turned downward during those recessionary periods.

Table 1 shows some details about the duration and severity of post-war recessions. The average length of post-war recessions was 11 months, with the two most recent showing how much the duration can vary. The 1980 recession lasted only six months, while the 1981–1982 recession lasted 16 months.

The severity also varied a great deal. The average increase in the unemployment rate from the business cycle peak to the trough was 3 percentage points, while the decline in GNP averaged a little more than 2 percent. In the past twenty years, there has been a clear relationship between the length of a recession and its severity. For instance, the 1973–1975 and the 1981–1982 recessions were significantly longer and deeper than the 1980 recession. The former two recessions lasted nearly a year and a half and saw the unemployment rate surge 3½ to 4 percentage points. The 1980 recession lasted only half a year, with only a 1½ percentage point increase in the unemployment rate.

The forecast 1990–1991 recession is expected to be extremely mild compared to the other post-war recessions. Our forecast calls for a peak in the third quarter of 1990 and a trough in the first quarter of 1991. The unemployment rate is only expected to rise a little more than 1 percentage point and real GNP is only expected to fall about 1 percent. In both duration and severity, it is much more likely to resemble the 1960–1961 recession than the much deeper recessions of the 1940s, 1950s, 1973–1975, and 1981–1982.

Thomas M. Holloway
Senior Economist

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUN	1,189	931	258	1,108	844	264	113	241	535	300	121	224	428	335
JULY	1,153	904	249	1,082	838	244	113	225	493	322	111	227	428	316
AUG	1,142	872	270	1,050	818	232	118	241	440	343	112	225	402	311
SEPT	**1,135**	**913**	**222**	**1,006**	**781**	**225**	**105**	**249**	**453**	**328**	**105**	**227**	**391**	**283**
1989 TOTAL	1,376	1,059	318	1,338	999	340	179	266	536	396	179	252	505	402
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
9 MONTH AVG. (SAAR)														
1990	1,267	986	281	1,187	898	289	137	271	500	359	134	265	446	343
1989	1,399	1,073	326	1,339	1,000	339	190	265	548	396	185	254	508	392
1988	1,474	1,130	344	1,433	1,056	377	251	265	566	391	240	259	534	401

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
MAY	3,300	2,740	9.9	536	360	8.2
JUN	3,330	2,650	9.6	559	354	7.8
JULY	3,330	2,570	9.3	558	350	7.7
AUG	**3,500**	**2,720**	**9.3**	**550**	**343**	**7.7**
1989 TOTAL	3,440	---	---	650	---	---
1988 TOTAL	3,594	---	---	676	---	---
8 MONTH AVG. (SAAR)						
1990	3,389	---	---	564	---	---
1989	3,435	---	---	656	---	---
1988	3,499	---	---	671	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

1990	Total[5]	1–Unit	2+ Units	Nonresidential
MAY	$303.9	$105.7	$19.1	$93.5
JUN	299.1	101.8	17.0	95.4
JULY	301.8	100.1	17.0	99.1
AUG	**295.6**	**98.2**	**17.2**	**94.7**
1989 TOTAL	308.5	108.3	20.7	96.0
1988 TOTAL	314.4	112.0	21.4	93.5
8 MONTH AVG. (SAAR)				
1990	306.0	106.7	17.9	95.4
1989	312.1	110.4	21.3	96.0
1988	314.9	111.6	21.5	93.8

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1990 FEB	$30,365	$9,867	$9,964	$10,129	$27	$3,041	$682	$803	$768	$551	$14,039	$202	$881	$9,469	$3,320
MAR	33,747	8,703	12,620	12,014	29	2,765	557	1,120	802	61	18,878	102	893	14,794	2,978
APR	32,585	7,543	12,295	12,405	28	1,597	145	940	317	50	16,510	100	703	12,240	3,048
MAY	**34,554**	**8,782**	**12,019**	**13,332**	**27**	**1,983**	**233**	**878**	**649**	**41**	**15,221**	**110**	**621**	**10,618**	**2,772**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85,307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
5 MONTH AVG.															
1990	33,041	8,939	11,584	12,092	72	2,522	497	925	663	216	16,373	133	771	12,010	3,051
1989	27,376	5,320	12,859	8,813	77	2,535	293	1,293	534	176	10,544	106	1,498	7,180	1,623
1988	27,363	6,360	12,978	7,562	131	2,578	246	1,445	477	256	14,860	47	1,928	10,847	1,788

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
					TOTAL		FHA		VA		PRIVATE	
	TOTAL	FHA[8]	VA	PRIVATE	Units	Amount	Units	Amount	Units	Amount	Units	Amount
1990 MAY	155	93	17	45	112	$8,919	65	$4,382	15	$1,236	32	$3,300
JUN	150	90	17	43	112	9,010	64	4,289	16	1,309	32	3,412
JUL	144	84	15	45	118	9,652	67	4,509	15	1,254	36	3,889
AUG	**154**	**89**	**18**	**47**	**126**	**10,074**	**70**	**4,764**	**19**	**1,573**	**37**	**3,937**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
8 MONTH AVG.												
1990	147	88	17	42	115	9,015	67	4,395	17	1,357	31	3,263
1989	143	85	16	42	100	7,558	56	3,488	15	1,160	29	2,910
1988	154	85	17	52	111	8,119	58	3,530	17	1,272	36	3,317

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[2] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[3] Effective rate on loans closed.

[4] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

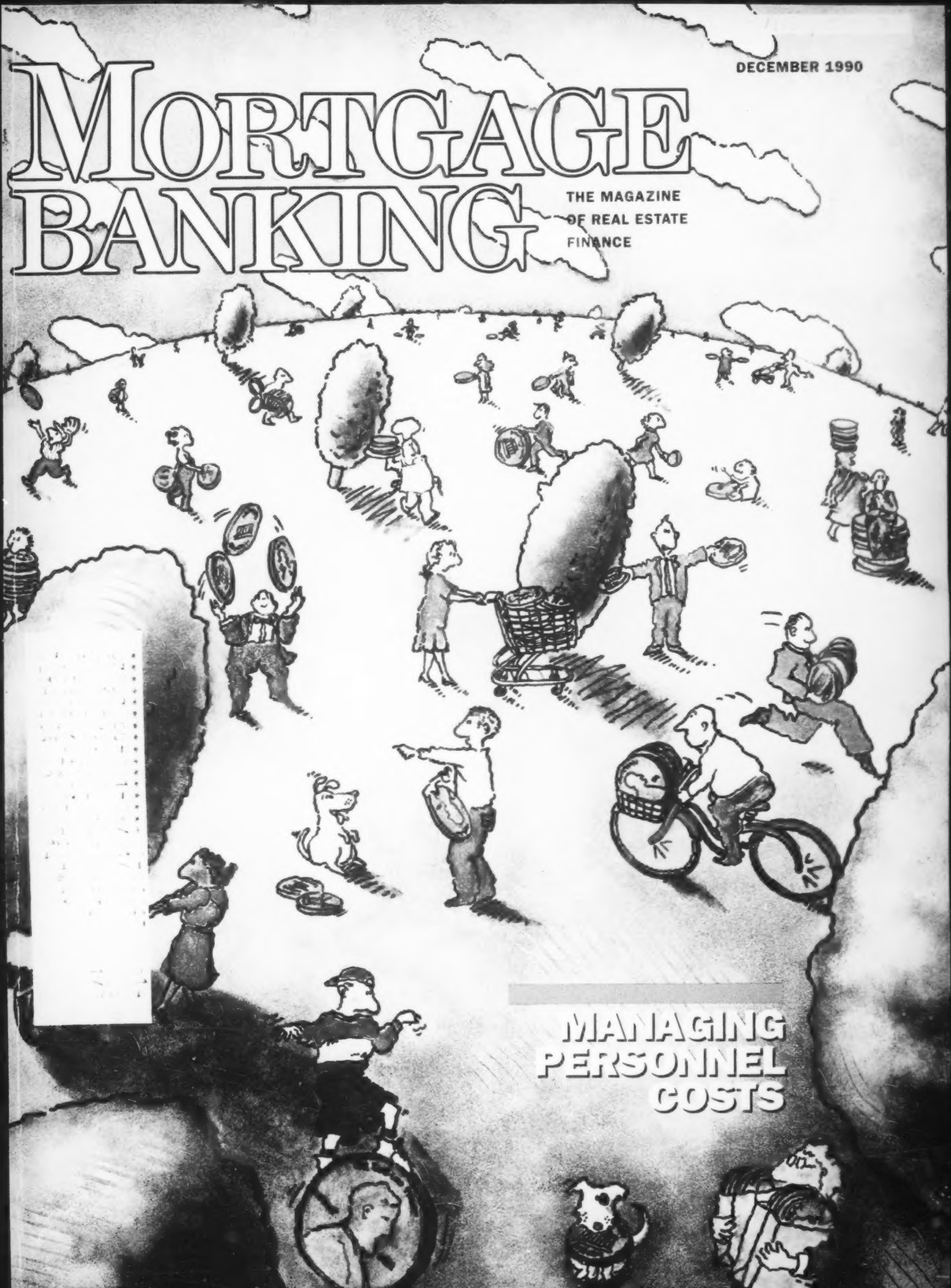
[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

DECEMBER 1990

MORTGAGE BANKING

THE MAGAZINE
OF REAL ESTATE
FINANCE



MANAGING PERSONNEL COSTS

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Compensation and Personnel

Mortgage bankers are watching every penny today. With origination volume down, cost control is more critical than ever. Salaries and other forms of compensation make up a big part of every lender's expenses. Our cover report focuses on what lenders are doing to make their pay schemes produce the biggest bang for the buck.

10 Executive Compensation *If you are CEO of an independent mortgage company based in California, the odds are you make significantly more than your Midwest counterpart. That's one of the findings of a major industry survey on mortgage managers' pay.* By CHIP THOMAS

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COVER ILLUSTRATION BY LINA CHESAK

PORTFOLIO

Compensation Complexities

The industry's top executives face major league headaches today. The risks are outrageous and the stakes are high. There is wreckage from past mistakes strewn all about the financial landscape. So maybe that's why the survivors, and particularly those shepherding companies through real growth stages during these difficult times, are being compensated quite nicely for their success.

Our cover report examines the complexities of compensation for the mortgage industry's top rung of managers. The results of a major industry survey of more than 60 mortgage operations reveal some intriguing nuances on the types of companies that reward certain manager's positions more richly than others. The clear implication is that companies value different management expertise differently, depending on their strategic mission.

The annual Sibson & Company survey focuses on generally large players in terms of both originations and servicing. Those represented in the survey account for one out of every three loans originated in 1989. The survey made a few interesting discoveries—for example, in companies classified as fast-growth origination operations, the top production executive earned on average $40,000 less than in companies categorized as low-growth originators.

Compensation for the industry's top servicing jobs squared more with expectations. For companies with the largest servicing portfolios, the top servicing executive earned on average $135,700 versus an average of $87,700 for the small servicers in the survey group. Large servicers also paid their top systems person an average $103,500, while the smaller servicers paid that executive $87,900 on average. Finally, geography plays a big role in how much the CEO makes, the survey shows. CEOs in the West made an average $385,900, while their colleagues in the East made an average $241,100, based on the companies surveyed.

However, what the lead article shows most convincingly is that what mortgage companies pay many of their top managers tends to vary and does not lend itself consistently to neat explanations based on company size, growth patterns or locations. Which goes to show that this industry is a collection of many varied operations choosing different paths to get the job done.

Janet Reilley Hewitt
Editor in Chief

EDITOR'S NOTE: An article that appeared in the November issue titled, "The Inside Line on Warehouse Lending" should have credited a co-author, Rosa L. Kroesen, vice president of Asset Backed Capital Research, Inc. and editor of *Wholesale Access.*

COMING IN JANUARY

How bad will the recession be and where are originations and interest rates headed? Lyle Gramley, MBA chief economist, will tackle those subjects next month. We will also cover the long-term outlook and one sizzling market—Nevada—in our first issue of the new year. Happy Holidays.

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Executive COMPENSATION

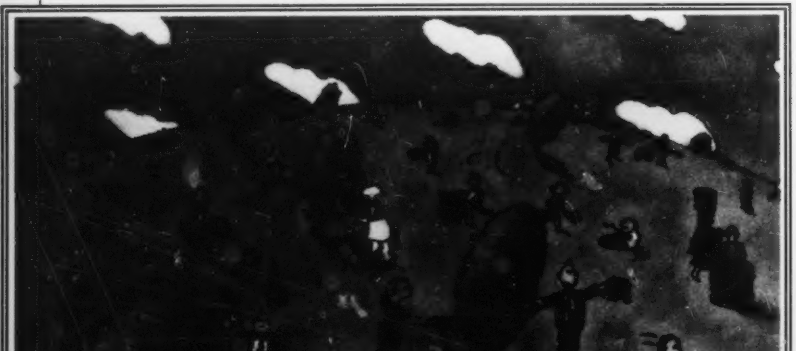

ILLUSTRATION BY LINA CHESAK

If you are CEO of an independent mortgage company based in California, the odds are you make significantly more than your Midwest counterpart. That's one of the findings of a major industry survey on mortgage managers' pay.

Chip Thomas

> *"I was promised on a time*
> *To have reason form my rhyme,*
> *From that time unto this season,*
> *I received neither rhyme nor reason."*
> ——— EDMUND SPENSER (1552-1599)

Executive compensation packages for mortgage companies were hardly the thing that set Mr. Spenser off back in the sixteenth century. He had his own reasons for ruing the lack of rhyme or reason. But, as it turns out, his lament about the absence of rhyme or reason neatly fits the state of typical top managers' pay packages common in the twentieth century. After Sibson & Company examined the pay programs of more than 60 of the largest mortgage bankers for the "1990 Mortgage Banking Compensation Survey," it is quite apparent that most organizations are still struggling today with how to pay their senior managers.

This article focuses on seven senior management positions and examines the level of pay those managers are receiving in the context of five "measures" of their company's traits. The salary data is reported as of April 1990 and the bonus and incentive data is surveyed for calendar year 1989. In fairly broad terms, our research found evidence of higher levels of pay at higher (or better) levels of performance. However, there were many exceptions—and the relationship between higher levels of pay and higher levels of performance proved not a very strong one.

We conclude this article with a discussion on how mortgage company executives can introduce reason into the executive compensation program. While there are no absolutes, we suggest a conceptual framework that we have found extremely useful in the development of executive compensation packages.

Source of information

Sibson & Company, Inc., Los Angeles, annually conducts a survey of compensation practices in the residential mortgage banking industry. Participants are generally large players in terms of both origination volume and size of their servicing portfolio. In total, these 60-plus organizations originated one out of every three loans in 1989. In aggregate, the servicing portfolios of these organizations totaled in excess of $500 billion. All of the companies in this analysis are subsidiaries, or parts of larger financial organizations.

From each of these companies, we collected and verified total cash compensation information for the following senior management positions: chief executive officer, chief financial officer, top production executive, top secondary marketing executive,top servicing executive, top human resource executive and top MIS executive. We then examined the pay levels based on the company's results in four overall measures. Specifically, the measures used were:

- Growth (in servicing portfolio and origination volume)
- Size (in servicing portfolio and origination volume)
- Independence of mortgage operation
- Geographic location

Pay versus growth

Our first point of inquiry was to determine if faster-growth companies tend to pay more than slower-growth companies. Clearly, the demands on senior management in a high-growth operation are greater. Also, a high-growth mode indicates that the parent organization views the mortgage banking industry in a positive light and is investing in the industry. Finally, we also know that profitable growth is the only way—in the long run—to increase the value of an organization.

To assess the relationship of total cash compensation to growth, we grouped the organizations into three categories: high growth, moderate growth and no growth or decline. Further, we separately assessed growth based on increases in servicing portfolio and increases in origination volume. The sample group of companies contained a relatively equal number from all three categories. Fortunately, there was not a significant difference in the sizes of the companies in each of the three groups.

As can be seen by examining Charts 1 and 2, a minor relationship exists between high growth in servicing portfolio and higher levels of compensation. However, the relationship between growth in origination volume and compensation is almost completely reversed from what one would reasonably expect.

The biggest anomaly, in our view, is the compensation data for the position of top production executive. Fast-growing organizations, on average, pay this position more than $40,000 less than comparable positions in low-growth companies.

While we do not believe we can explain away the complete lack of relationship between growth and compensation—several factors are at work that may erode the strength of the relationship. The most significant factor is that the "growth" (especially for fast-growing servicing portfolios) is frequently being paid for by the parent company. That is, the parent company is redirecting its assets to the mortgage subsidiary—so the growth is not coming solely from the performance of the mortgage operation.

Another factor, especially pertinent in the area of servicing, is the traditional second-class citizenship of the servicing function. In studies with mortgage companies, we have found that the basic job of the top servicing executive is not as well understood by management as is the role of the manager running the secondary marketing or the production functions. With many companies aggressively moving into servicing, we anticipate that the level of understanding will increase.

Finally, it is not uncommon to see companies being reluctant to reduce pay (or the size of bonus checks) in times of slow growth. While we know this is human nature, it does distort the relationship between growth and compensation, because companies pay out large bonus checks in good times and large bonus checks in bad times.

Pay versus size

In many industries, the strongest correlation can be found between the absolute size of the company and the pay of senior executives. Usually, for a given company size, pay will cluster within a plus or minus 20 percent range for a given position.

This finding is also applicable to mortgage companies. For the four years that we have conducted this compensation survey, we have found that annual origination volume is a reasonably good predictor (generally better than servicing portfolio size) of pay levels—but again, there are exceptions.

Charts 3 and 4 present the various total cash compensation levels for large, medium and small companies measured by origination volume and by servicing portfolio size. For origination volume, the strongest relationship exists for the top production executive. This does make sense, given that this position is directly responsible for overseeing the production activity of the company. The relationship is further strengthened because a significant percentage of companies still base a portion of the incentive dollars on the absolute dollar volume of originations.

The relationship of the chief financial officer's pay to the company's size was also strong when compared to the size of the origination volume—far stronger than the relationship of the CFO's pay compared to the size of the servicing portfolio. This perhaps suggests that the CFO is valued more for his or her input in the area of pricing loans than in the financing and acquisition of servicing.

We found that the largest companies, in terms of servicing portfolio size, do pay their top servicing executive significantly more than at either the medium- or small-sized servicing operations. Upon closer examination of the survey data, it appears that a common level of pay exists (at around $90,000) for managing servicing portfolios up to about $8 billion in size. Beyond that, the pay starts to climb fairly rapidly with the size of the servicing portfolio.

Not surprisingly, the top MIS executive follows the same pattern as the top servicing executive in terms of compensation. In many mortgage companies, the MIS function primarily supports the servicing function. In fact, for the largest servicing companies, the MIS function is critical to realizing the benefits of the economies of scale predicted by having a large servicing portfolio.

Pay versus independence

We anticipated that we would see clear differences from the survey in the pay of senior executives based on their autonomy from the parent company. Again, we divided our sample group of companies into three categories based on their independence. The following categories of independence were identified: highly independent from parent company; subsidiary, but share services with parent company; and stand-alone department within parent company.

As can be seen in Chart 5, the independence of the mortgage company is clearly an important factor influencing the pay of the chief executive officer and the chief financial officer. There also appears to be a positive relationship for the top production executive and the top secondary marketing executive that traces back to this corporate identity question. Unfortunately, the participants that were best characterized as "departments" are very large, making true comparisons difficult.

A strong relationship also existed for the top MIS executive and the top human resource executive. In organizations that are run autonomously from the parent, the MIS and human resource function are more likely to be free-standing and responsible for both the design and the implementation of programs. In less independent companies (our second category), frequently MIS and human resources units receive oversight from the parent company—limiting their role to one of implementation and administration rather than design.

Pay versus geography

Finally, in Chart 6, we also sought to discover if geography significantly influenced the pay levels of senior exec-

CHART 1

Average Total Cash Compensation

(By Growth in Servicing Portfolio)

	HIGH	MODERATE	LOW
Chief Executive Officer	$347.2	$295.0	$226.7
Top Financial Officer	136.2	N/A	115.1
Top Production Executive	158.9	149.9	159.2
Top Secondary Marketing Executive	134.2	119.6	143.5
Top Servicing Executive	89.1	126.4	101.0
Top MIS Executive	98.8	85.7	84.5
Top Human Resource Executive	104.8	56.9	71.4

CHART 2

Average Total Cash Compensation

(By Growth in Origination Volume)

	HIGH	MODERATE	LOW
Chief Executive Officer	$262.9	$289.4	$355.7
Top Financial Officer	144.3	133.9	139.0
Top Production Executive	133.2	166.4	176.4
Top Secondary Marketing Executive	128.7	130.5	148.0
Top Servicing Executive	107.5	84.7	106.1
Top MIS Executive	91.0	80.6	104.2
Top Human Resource Executive	80.0	74.6	81.5

CHART 3

Average Total Cash Compensation

(By Origination Volume)

	LARGE	MEDIUM	SMALL
Chief Executive Officer	$337.9	$284.3	$262.5
Top Financial Officer	179.0	125.7	113.1
Top Production Executive	194.3	155.1	107.7
Top Secondary Marketing Executive	150.6	140.8	86.7
Top Servicing Executive	119.2	116.9	90.7
Top MIS Executive	96.3	80.9	75.9
Top Human Resource Executive	92.8	83.3	56.1

CHART 4

Average Total Cash Compensation

(By Servicing Portfolio)

	LARGE	MEDIUM	SMALL
Chief Executive Officer	$306.3	$281.9	$307.7
Top Financial Officer	158.4	140.7	145.2
Top Production Executive	175.8	146.6	154.1
Top Secondary Marketing Executive	154.1	112.5	128.4
Top Servicing Executive	135.7	89.9	87.7
Top MIS Executive	103.5	76.1	87.9
Top Human Resource Executive	79.5	76.8	70.2

CHART 5

Average Total Cash Compensation

(By Independence of Operation)

	IND.	SHARED	DEPT.
Chief Executive Officer	$320.6	$256.3	N/A
Top Financial Officer	157.3	129.7	N/A
Top Production Executive*	169.9	142.3	157.9*
Top Secondary Marketing Executive	144.6	113.4	130.6*
Top Servicing Executive	91.7	108.4	120.9
Top MIS Executive	90.7	76.5	N/A
Top Human Resource Executive	86.3	61.4	N/A

* Origination volume of departments was double that of other categories.

CHART 6

Average Total Cash Compensation

(By Geographic Location)

	WEST	CENTRAL	EAST
Chief Executive Officer	$385.9	$272.6	$241.1
Top Financial Officer	186.1	116.7	158.3
Top Production Executive	176.8	122.0	156.5
Top Secondary Marketing Executive	141.3	93.1	134.3
Top Servicing Executive	114.7	75.8	118.9
Top MIS Executive	88.1	70.9	78.1
Top Human Resource Executive	70.1	74.3	72.3

utive positions in the mortgage banking business. Conventional wisdom would suggest that we would not find a strong relationship. While we all agree that geographic differences are very real for nonexempt positions, most "experts" (including ourselves) would argue that the labor market for the top executives is truly national—not regional.

However, we found that with the exception of the top human resource executive and the top servicing executive, West Coast companies do pay significantly more than their counterparts in other parts of the country.

It is our theory that the difference in pay for the West Coast (primarily California-based mortgage companies) was partially based on a higher cost of living. It is also a reflection of the significant movement of senior executives between mortgage companies. In the development of hiring packages to lure executives, companies frequently are forced to provide a de facto geographic differential in the form of a higher starting base-salary.

Summary of results

In looking at the four macro factors of growth, size, independence and geographic location, it does appear that there is a rational explanation after all, for the pay levels of senior executives—though you will need to look at a combination of factors to establish what that explanation is. Chart 7 displays the strength of the relationship of each measure to the compensation of the senior executives. For example, an independent, California-headquartered, mortgage company chief executive officer will probably earn significantly more than a Midwest-based chief executive officer of a subsidiary where the parent company takes a close interest in operations.

Annual origination volume is a reasonably good predictor (generally better than servicing portfolio size) of pay levels—but again, there are exceptions.

However, there is one position where the results are definitely muddled. The majority of the data suggests that top servicing executives, no matter what the characteristics of the company, are paid roughly the same. The exception is with companies with truly large—in excess of $10 billion—servicing portfolios.

Determining appropriate pay

If you're looking for some guidance from this as to appropriate compensation levels for your top managers, there is no escaping the conclusion that the landscape is confusing. Companies cannot turn, with any degree of confidence, to any one single measure and develop an appropriate compensation level. In fact, you not only need to know how much to pay a position, but how much of that pay should be in the form of base-salary versus incentives, how the incentives will be determined and so forth. So how do you develop a compensation program that is reasonable—both to the organization and to the executive group? We recommend the following procedures.

CHART 7

Strength of Relationship Between Measure and Total Cash Compensation

	GROWTH		SIZE			
	Servicing Portfolio	Origination Volume	Servicing Portfolio	Origination Volume	Independence	Geography
Chief Executive Officer	●	○	◐	●	●	●
Top Financial Officer	○	○	○	●	●	●
Top Production Executive	○	○	○	●	○	◐
Top Secondary Marketing Executive	○	○	○	●	○	◐
Top Servicing Executive	○	○	●	○	○	○
Top MIS Executive	◐	○	●	◐	◐	○
Top Human Resource Executive	○	○	○	●	◐	○

STRONG	●
MODERATE	◐
WEAK	○

First, the organization needs to determine the ground rules. The ground rules for compensation, in total, establish the direction that management desires to take compensation.

The primary ground rule governs the role, or prominence, that compensation is going to play in your organization. For example, do you want to use pay to actively change executives' behavior and to drive the strategy of the organization? Or, do you simply want to ensure that your pay program does not dissatisfy, and let the pay package be more passive in terms of promoting the desired behavior?

Historically, pay has played a highly prominent role in mortgage banking organizations—pay being the primary yardstick by which performance is measured. Given that many senior executives used to be loan officers on 100 percent commission, this continued prominent role for pay in the mortgage banking industry is not that surprising. Prominent pay programs generally have very distinct characteristics. For example, they tend to provide for a larger incentive opportunity. Usually, the incentive is based on very explicit, quantifiable, individually influenced performance objectives. Also, the actual range of payouts, over time, will vary significantly. Prominent pay programs also require more frequent modification.

A second important ground rule (and the one most often neglected), is to establish the basic objectives of the compensation program. We know that executive compensation programs, at a minimum, need to attract and retain executives. But there are other objectives that will be appropriate in a given situation. Examples include the following basic objectives:

Foster teamwork. Encourage executives to work in a more collaborative style.

Reward risk-taking. Provide the incentive for executives to take appropriate risks.

Promote "ownership" behavior. Executives should act like owners, not like caretakers.

The third important ground rule for

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establishing pay programs is to determine what external reference points will be used to compare your pay levels against, and how strongly they will be emphasized as a point of comparison. We believe it is very important for all companies to understand how their compensation program stacks up against the competition; that is, those companies you compete against for business and those companies whom you are likely to recruit executives from and/or lose executives to.

Ideally, the companies that you use as external references should be as similar as possible. For example, the majority of the organizations that you identify as external references should be: equally independent in terms of business operation; similar in size and organization; and similar in style and culture.

Beyond the ground rules

After the ground rules have been established, you are ready to proceed to actually developing the appropriate compensation levels. The ground rules, in combination, will allow you to sort through the infinite number of possibilities. With the ground rules identified, you will know: how aggressive you want to be with your pay program, what are the appropriate objectives of the program and what the competition is doing.

Armed with the answers to these questions, you will be in a far better position to determine what level of pay is appropriate for a given position and how that pay should be structured. Also, and critically important, you will know when you should follow competitive practice and when competitive practice should be ignored.

The final point we wish to stress is that it is not that important, ultimately, whether or not we can find any rhyme or reason in the compensation practices of this industry. That is not the proper context for determining whether or not prevailing pay levels make sense. The only important place for a compensation program to pass any test of appropriateness and rationality is inside the company where it has been adopted. **MB**

Chip Thomas is a senior consultant with Sibson & Company, Inc. based in Princeton, New Jersey, a human resources management firm specializing in the design of compensation programs.

VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHFB			FNMA		FHLMC	
	FHA	CONVENTIONAL[2]						
1990	New Homes[1]	FRM	ARM	Median Cost of Funds SAIF Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
JUL	10.15%	10.51%	9.25%	NA	8.14%	9.88%	8.43%	10.04%
AUG	10.20	10.33	9.18	NA	7.96	10.00	8.35	10.10
SEP	10.26	10.33	9.06	NA	7.96	10.07	8.28	10.18
OCT	**NA**	**NA**	**NA**	**NA**	**7.84**	**10.08**	**8.20**	**10.17**

SELECTED SECURITIES

		PRIME COMMERCIAL	U.S. GOVERNMENT				
1990	FEDERAL FUNDS RATE	PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
JUL	8.15%	7.99%	7.52%	7.94%	8.26%	8.47%	9.96%
AUG	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT	**8.11**	**7.98**	**7.16**	**7.55**	**8.07**	**8.72**	**10.23**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1990	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
JUL	9.66%	9.66%	9.66%	119	119	119
AUG	9.80	9.75	9.75	105	100	100
SEP	9.86	9.79	9.73	97	90	84
OCT	**9.84**	**9.80**	**9.69**	**112**	**108**	**97**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA*				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1990	Commitments**	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
JUN	$2,089	$1,802	$263,330	$8,266	$5,549	$11,183	$5,856	$5,546	$6,851	$5,738
JUL	2,215	2,304	268,052	6,869	4,507	5,851	4,527	4,247	8,553	5,553
AUG	2,302	2,134	275,227	9,378	6,279	5,645	5,417	4,808	4,489	6,560
SEP	**2,073**	**2,123**	**281,806**	**8,953**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
1989 TOTAL	27,409	22,518	---	69,764	85,408	86,263	78,589	73,518	60,149	57,522
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
8 MONTH AVG.										
1990	1,924	1,923	---	8,045	6,028	7,710	5,748	5,768	5,336	5,389
1989	2,157	1,655	---	4,921	6,214	6,530	5,806	5,344	4,395	4,394
1988	2,117	2,033	---	4,363	2,927	5,251	3,237	2,829	4,676	4,366

*FNMA year to date averages are for nine months.

**Does not include standby commitments issued, but includes standby commitments converted.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUN	1,189	931	258	1,108	844	264	113	241	535	300	121	224	428	335
JUL	1,153	904	249	1,082	838	244	113	225	493	322	111	227	428	316
AUG	1,142	872	270	1,050	818	232	118	241	440	343	112	225	402	311
SEP	**1,135**	**913**	**222**	**1,006**	**781**	**225**	**105**	**249**	**453**	**328**	**105**	**227**	**391**	**283**
1989 TOTAL	1,376	1,059	318	1,338	999	340	179	266	536	396	179	252	505	402
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
9 MONTH AVG. (SAAR)														
1990	1,267	986	281	1,187	898	289	137	271	500	359	134	265	446	343
1989	1,399	1,073	326	1,339	1,000	339	190	265	548	396	185	254	508	392
1988	1,474	1,130	344	1,433	1,056	377	251	265	566	391	240	259	534	401

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
JUN	3,330	2,650	9.6	550	354	7.9
JUL	3,330	2,570	9.3	545	350	7.9
AUG	3,500	2,720	9.3	535	345	7.9
SEP	**3,220**	**2,560**	**9.5**	**503**	**337**	**8.4**
1989 TOTAL	3,440	---	---	650	---	---
1988 TOTAL	3,594	---	---	676	---	---
9 MONTH AVG. (SAAR)						
1990	3,370	---	---	554	---	---
1989	3,443	---	---	654	---	---
1988	3,509	---	---	675	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

1990	Total[5]	1–Unit	2+ Units	Nonresidential
JUN	$299.1	$101.8	$17.0	$95.4
JUL	300.8	100.0	16.9	99.0
AUG	294.1	98.1	16.9	94.1
SEP	**289.4**	**96.0**	**16.4**	**92.2**
1989 TOTAL	308.5	108.3	20.7	96.0
1988 TOTAL	314.4	112.0	21.4	93.5
9 MONTH AVG. (SAAR)				
1990	303.8	105.5	17.7	94.9
1989	311.4	109.8	21.2	96.2
1988	314.6	111.6	21.5	93.7

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED

By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1990 FEB	$30,305	$9,867	$9,964	$10,129	$27	$3,041	$682	$803	$768	$551	$14,039	$202	$881	$9,469	$3,320
MAR	33,747	8,703	12,620	12,014	29	2,765	557	1,120	802	61	18,878	102	893	14,794	2,978
APR	32,585	7,543	12,295	12,405	28	1,597	145	940	317	50	16,510	100	703	12,240	3,048
MAY	**34,554**	**8,782**	**12,019**	**13,332**	**27**	**1,983**	**233**	**878**	**649**	**41**	**15,221**	**110**	**621**	**10,618**	**2,772**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85,307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
5 MONTH AVG.															
1990	33,041	8,939	11,584	12,092	72	2,522	497	925	663	216	16,373	133	777	12,010	3,051
1989	27,376	5,320	12,859	8,813	77	2,535	293	1,293	534	176	10,544	106	1,498	7,180	1,623
1988	27,363	6,360	12,978	7,562	131	2,578	246	1,445	477	256	14,860	47	1,928	10,847	1,788

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
MAY	155	93	17	45	112	$8,919	65	$4,382	15	$1,236	32	$3,300
JUN	150	90	17	43	112	9,010	64	4,289	16	1,309	32	3,412
JUL	144	84	15	45	118	9,652	67	4,509	15	1,254	36	3,889
AUG	**154**	**89**	**18**	**47**	**126**	**10,074**	**70**	**4,764**	**19**	**1,573**	**37**	**3,937**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
8 MONTH AVG.												
1990	147	88	17	42	115	9,015	67	4,395	17	1,357	31	3,263
1989	143	85	16	42	100	7,558	56	3,488	15	1,160	29	2,910
1988	154	85	17	52	111	8,119	58	3,530	17	1,272	36	3,317

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

JANUARY 1991

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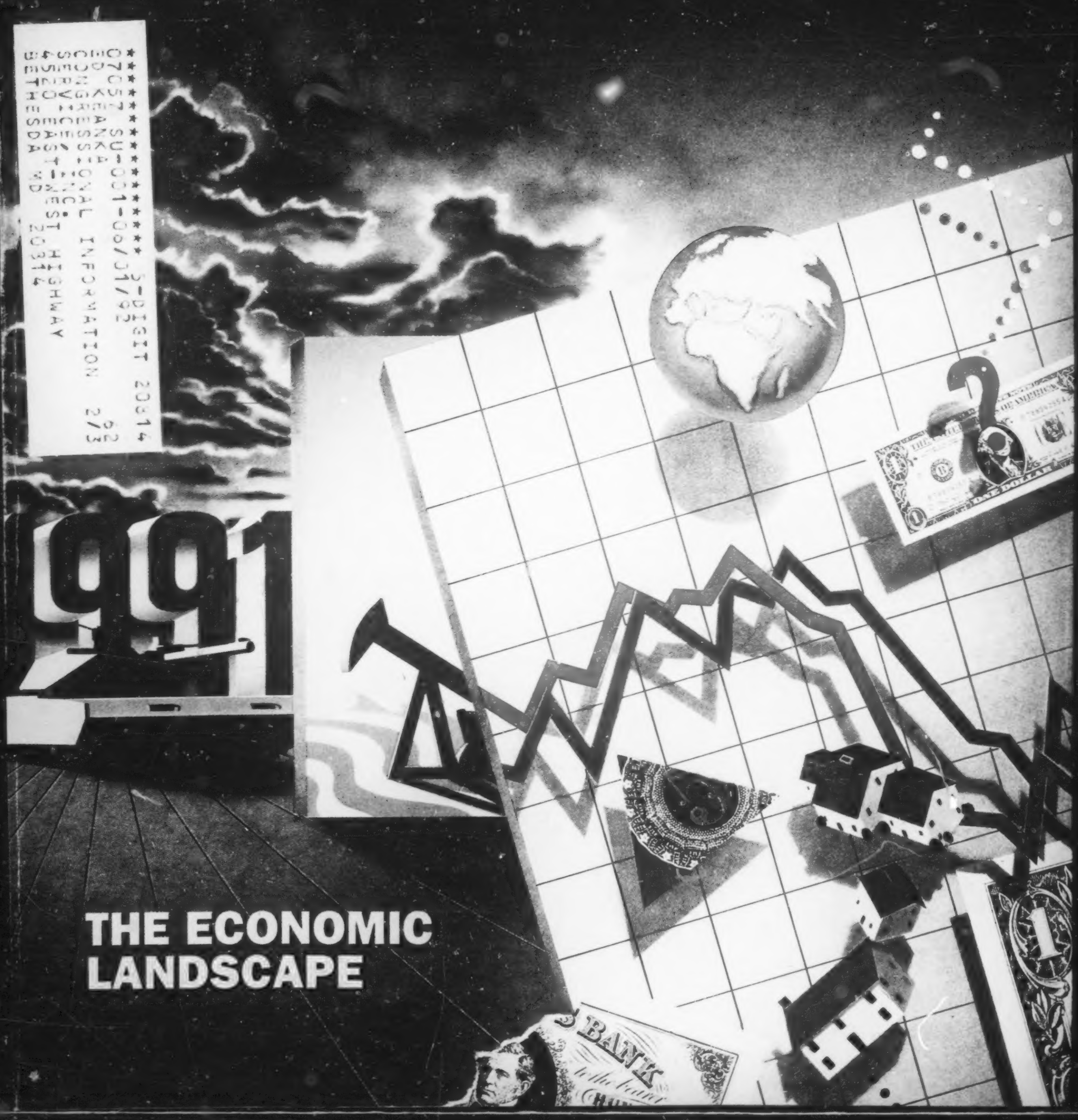

THE ECONOMIC LANDSCAPE

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The Middle East crisis looms as the central variable shaping the economic outlook for this year. The credit markets are watching Kuwait and the calendar and waiting to react. Ironically, Saddam Hussein has virtually eclipsed Alan Greenspan as the person most likely to catapult the bond markets into some new frenzy of activity. Welcome to 1991.

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COVER ILLUSTRATION BY DICKRAN PALULIAN

Future Visions

As our cover suggests, we are hunkering down for a year when military events and oil seem likely to hold the capital markets hostage. For lenders, the volatility in the market could promise a real roller coaster ride in 1991. For borrowers, the year might be one when the art of deciding when to lock rates is finally perfected or at least studied very seriously.

Because Saddam Hussein's next move is difficult to forecast, we asked our forecasters to stick to economic fundamentals. Our cover report scopes out the near-term outlook for the U.S. economy. And surprisingly enough, the news is not that grim for an economy entering recession. Our eyes into the future—MBA Chief Economist Lyle E. Gramley—says by this year's second half, economic activity and single-family construction are expected to turn up again. The article makes the case as to why this recession is likely to be neither prolonged or severe, as recessions go. But Gramley does predict that: "Some banks, already in a weakened condition, will not survive the recession, and some insurance companies may also fail."

So, the forecast for 1991 is not for a roaring good year. But it could be worse. The long-term prospects for the housing market are also included within the covers of this issue, in case the short-term ones leave you less than satisfied. Fannie Mae's Chief Economist David Berson goes on the record with the prediction that "30-year fixed-rate mortgages should average a bit above 9 percent in the coming decade." Since everyone knows economists are hesitant to forecast very far out into the future, we applaud the daring of this author to go for broke.

Finally, another offering this month tries to put last year's housing legislation in some perspective. Congress remains very much caught up with the chilling memory of the thrift crisis and its costly aftermath. We offer you the thoughts of some key policymakers who had to make tough decisions on the FHA program in the wake of the painful episode with the thrifts. It may shed some light on why Congress passed reforms that many say erred on the side of overkill.

Janet Reilley Hewitt
Editor in Chief

COMING IN FEBRUARY

Servicing managers face some tough issues as the recession arrives and delinquencies pick up. The next issue will focus on ways to prevent foreclosures, as well as geographic markets where delinquencies are on the rise. We will also offer tips for boosting servicing productivity.

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ECONOMIC PROSPECTS FOR 1991

The current recession will be mild and relatively short, unless of course, the Gulf crisis erupts. By the second half of 1991, homebuilding and economic growth should be rebounding.

Lyle E. Gramley

Writing about economic prospects is much more fun when the outlook is bright and cheery. But after seven good years and one rather lean one, the economy's prolonged growth since late 1982 has come to an end: 1991 will mark the first recession year since 1982 and the ninth recession of the postwar period.

Forecasting in the midst of an economic downturn is always a chancy business because the dynamics of a decline are hard to predict. This year, the usual difficulties are exacerbated by a series of events and problems that might convert a mild decline into a severe and prolonged one. The Middle East crisis has weakened consumer and business confidence and eroded real income through its impact on oil prices. Many financial institutions are weaker than at any time since the 1930s, and real estate markets in some areas are being battered in ways that have shaken local residents.

The economy of the United States, nonetheless, still has solid footings, and we believe the current recession will be relatively mild in both depth and duration. By the second half of 1991, economic activity and single-family housing construction are expected to turn up again, albeit with less than the usual vigor that is characteristic of earlier postwar recovery periods.

The case for a mild recession

The case for a mild recession rests on three pillars. The first is that absent a shooting war (and maybe even with one, although that is much less certain), oil prices will come down from the average level prevailing since August 2, 1990, to a range of $20 to $25 a barrel. The loss to world oil supplies of Iraqi and Kuwaiti production since August has largely been offset by the increased output of Saudi Arabia and other countries, so that world demand and supply for crude oil are in reasonably good balance. (Today's oil prices still reflect market fears of a disruption of supplies should a shooting war erupt.) Such a drop in crude oil prices—particularly if accompanied by an end to the Middle East crisis—would have a tonic effect on the economy. Consumer spending power would improve; inflation would abate, and consumer and business confidence would turn up again. The crisis in the Persian Gulf is not the only reason for the current recession, but it is a major contributor. Removing that growth impediment would be of major benefit to our overall economic health.

The second pillar on which the case for a mild recession rests is the state of inventories. On average during previous postwar recessions, roughly half of the decline in real GNP was accounted for by a sizable drop in inventory investment. Investment in business stocks will decline in this recession, too, but by modest proportions, because inventories have remained lean relative to sales. Growth in final sales began to slow noticeably early in 1989, as it often does late in an economic expansion. For a time, inventory-sales ratios rose a bit, but that prompted strong action by both manufacturing and trade firms to trim excess stocks. By March 1990, the ratio of inventories to sales for all manufacturing and trade firms had dropped a little below its level 15 months earlier. This remarkable restraint by businesses—aided by sophisticated inventory control systems—will diminish substantially the degree of downward pressure on the economy coming from the need to reduce inventories further as the recession proceeds.

Growing exports provide the third reason for expecting the U.S. economy to pull out of recession before too

ILLUSTRATION BY DICKRAN PALULIAN

Make no mistake about this: lenders have stopped shoving money down the throats of borrowers, as they did throughout much of the 1980s.

much damage occurs. Since the summer of 1986, U.S. net exports of goods and services have risen roughly $100 billion in constant dollar terms—about 2 percent of real GNP. The rate of increase was particularly rapid in 1987 and 1988, when the benefits of the dollar's fall in value in exchange markets from early 1985 to early 1988 were most strongly felt. Since then, the rise in net exports has been more subdued, but it is clearly not over. Growth abroad—in Asia as well as in Western Europe—is much stronger than in the U.S. Moreover, the dollar's international value has declined substantially further since mid-1989, thus greatly enhancing our competitive position in world markets. Indeed, measured in foreign currencies, prices of U.S. merchandise exports today are at about the same level as in late 1980. Prospects for a further increase in U.S. net exports during 1991 seem quite good, and that will help keep the economy from going into a free fall.

Based on these considerations, the MBA economics department forecast anticipates an upturn in the U.S. economy in the second half of this year—but a modest recovery. If inventory investment does not decline much, there is little room for the usual early recovery rebound. That factor alone would keep the recovery of moderate dimensions. Dampening the recovery still more will be the problems of financial fragility and weakness in real estate markets mentioned earlier. Some observers believe that these problems will keep the economy in a prolonged recession. Maybe, but we don't think so.

The credit crunch

The economy entered the current recession confronting a problem never before encountered in earlier postwar downturns: a financial system with lots of weak spots. The issue is not whether the fragility of financial markets will shape the contours of economic performance in 1991; that we know for sure. The question is whether financial fragility will doom the U.S. economy to a deep and prolonged recession.

A recession always magnifies the difficulties faced by lenders, because more loans go sour as business sales and profits decline. Some banks, already in a weakened condition, will not survive the recession, and some insurance companies may also fail. Lending standards all across the nation, and particularly in the Northeast, have already been tightened significantly, and will tighten still further as the recession proceeds. Will access to credit by private borrowers be so severely choked off as to prevent the economy's recovery altogether?

Confident answers to that question are impossible, but insights into how the financial system might respond can be gleaned from financial data available to date. Restraints on lending standards to private borrowers have been intensifying since mid-1989, spreading from residential builders and commercial property developers to businesses more generally, and widening from the Northeast to affect virtually every geographic region of the country. Nonetheless, at this writing, credit to the private sector continues to flow, albeit more slowly. Despite severe restrictions on bank lending to finance new multifamily and commercial construction, total real estate loans at commercial banks are still moving up. Despite a decline in commercial and industrial loans at all commercial banks since August 1990, total business short-term borrowing has risen further, as many businesses have met their short-term credit needs by issuing commercial paper in larger quantities.

These results reflect the fact that participants in financial markets over the past two decades have learned to cope with problems by innovating. A combination of earlier regulatory restraints and fierce competition have strongly encouraged innovative behavior by borrowers and lenders alike, and the lessons learned will stand them in good stead during 1991. Moreover, the aggregate supply of funds available for investment this year will increase—bank deposits will rise, pension fund assets will grow, and insurance company reserves for investment will increase. A larger-than-normal portion of the new funds will be invested in Treasury securities, as lenders seek greater safety. But with yield spreads between private securities and Treasury issues widening, lending to the private sector will remain attractive to strong financial institutions (of which there are many) who will search out and lend to businesses with a good bottom line and strong management, and individuals with the wherewithal to buy a home or a new car.

Make no mistake about this: lenders have stopped shoving money down the throats of borrowers, as they did throughout much of the 1980s. This will affect the ability of the U.S. economy to return to a strong economic growth rate once the recession is over. But we do not believe that credit shortages will become so severe as to prolong or deepen the recession unduly.

Real estate markets

Weakness in real estate markets also is thought to pose a threat to make the recession long and deep. Once again, it's possible, but we don't think it will happen.

There are two disaster areas within the general field of real estate: multifamily residential properties and commercial real estate—office buildings, shopping centers, hotels and motels. In both areas, activity (and vacancy rates) rose dramatically in the first half of the 1980s in response to federal tax laws that encouraged investment in buildings whose economic prospects were doubtful. When tax reform came along in 1986, multifamily housing starts began to fall, and are now only

Single-family housing starts will bottom out this spring, with the trough not far below current levels, and that activity will improve moderately in the second half when the overall economy shows signs of recovery.

one-third of their early 1986 level. The reaction of commercial construction to tax reform was delayed, however, as money continued to pour into the industry—particularly from failing savings and loan associations desperate for front-end fees. Both of these sectors of the real estate industry are now being hammered by severe constraints on the availability of credit.

Construction in both of these areas will decline further in 1991, exercising a drag on GNP growth throughout the year. This would be a major problem for the overall economy if activity in these two areas were a sizable part of the total economy; in fact, together they comprise less than 1½ percent of real GNP.

Other areas of nonresidential construction are doing reasonably well. Industrial construction in constant dollars rose 9 percent over the past year; construction carried on by state and local governments rose a similar amount. Construction of private nonresidential buildings other than industrial and commercial structures—such as hospitals and religious and educational buildings—rose 3 percent over the year. In all of these areas, which comprise around 2½ percent of real GNP, activity is expected to continue rising in 1991.

Single-family residential construction, by far the largest single element of the overall construction industry, is a separate case. Mortgage bankers are all well aware that single-family home sales and housing starts have been declining for more than four years. The rate of descent, however, does not begin to compare with the abrupt drop that occurred in the crunches of 1979-80, or 1981-82 (see Chart 1). Unfavorable demographic factors, persistently high real mortgage interest rates and rising unemployment during the current recession will continue to drag down housing activity in the months ahead, but the chance that housing starts will plunge as they did a decade ago is remote. Indeed, we believe that single-family housing starts will bottom out this spring, with the trough not far below current levels, and that activity will improve moderately in the second half when the overall economy shows signs of recovery.

The MBA housing forecast for 1991, shown in Table 1, can hardly be regarded as wildly optimistic. On average, we expect housing starts to be about 10 percent lower this year than last; both existing and new single-family home sales will be down. Mortgage loan originations on one- to four-family residences will probably be below $350 billion, the lowest level since 1985. Mortgage bankers are expected to capture a bit more than one-fourth of the market—a lower share than in 1990, but about the same as in 1989.

With the slower rate of growth of the underlying demographic demand for shelter, a substantially better year for the single-family housing market, and for residential mortgage lenders, would seem to rest heavily on the prospects for a substantial decline in mortgage interest rates, especially rates on fixed-rate mortgages. Continued high long-term interest rates abroad will probably prevent a major decline in U.S. long-term interest rates, unless and until the inflation rate in the U.S. begins to show signs of fundamental improvement. Rising unemployment this year—to a range of 6¾ to 7 percent by the second half—will increase the chances of a significant breakthrough on the inflation front. But it may well be 1992 before the Federal Reserve's efforts to curb inflation begin to bear ample fruit.

Lyle E. Gramley is chief economist for the Mortgage Bankers Association of America in Washington, D.C.

CHART 1

Single-Family Housing Starts

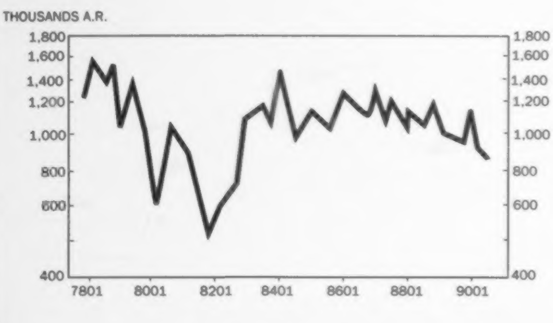

TABLE 1

MBA Housing Forecast

	1990	1991
Housing Starts: (000)		
Total	1,210	1,080
1-4 Family	950	880
Multifamily	260	200
Home Sales: (000)		
New Single-Family	540	520
Existing	3,250	3,200
Mortgage Loan Originations, 1-4 Family, Billions		
Total	$355	$345
Mortgage Bankers	100	90
Share	28%	26%

A Longer Perspective

Long-term interest rates should decline by about 350 basis points in the 1990s compared to their average during the last decade. That's the outlook by Fannie Mae's chief economist.

David W. Berson

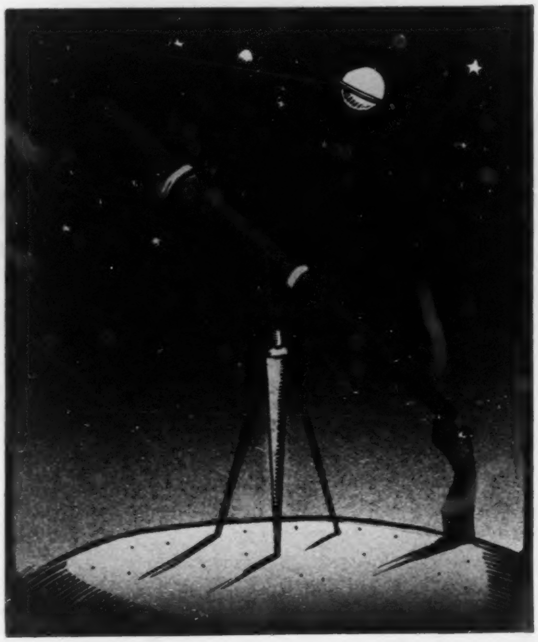

ILLUSTRATION BY RANDY LYHUS

The outlook for 1991 is dependent in large part on events in the Middle East. Because economists have no comparative advantage in forecasting military or political events, the outlook carries with it a higher degree of uncertainty than usual. But in general, Fannie Mae's outlook for the economy and the housing market in 1991 is similar to the forecast presented by Lyle Gramley, chief economist of the Mortgage Bankers Association.

The long-term outlook is yet another matter that carries its own degree of uncertainty. We will attempt to sort out some of the factors that will shape the economy in the years ahead.

The near-term outlook

We have made the assumption that the conflict in the Middle East will be resolved in the first quarter of 1991, either through negotiations or a quick and successful war. The impact on the U.S. economy should be similar in either case, although even a successful war carries risks for the short-term production and distribution of crude oil from the entire Gulf region. If events in the Middle East actually unfold in this manner, then oil prices should fall sharply during the first half of next year, sliding to $21-$23 per barrel by mid-year. This should also push the overall rate of inflation down abruptly from current levels.

The economy is likely to begin this year in the same fashion that it ended the last one—in a mild recession. The combination of lower inflation and reduced borrowing demands will allow long-term interest rates to decline. In addition, with the economy contracting, the Federal Reserve should continue easing monetary policy, pushing short-term rates down. The decline in rates will be constrained, however, for several reasons.

First, high real interest rates abroad and the continuing need for foreign financing of our budget deficit will keep domestic interest rates from falling quickly or far. Second, despite lower overall inflation in the first half of 1991, a mild recession is not likely to create enough slack in the economy to bring the "core" rate of inflation down appreciably—and that will help to prop up long-term rates and keep the Fed from easing dramatically. Finally, unless the economy is weaker than we expect, the Fed will probably not ease aggressively for fear that the dollar would drop precipitously. The weak economy should allow rates to fall through mid-year, with long-term rates declining by about 50 basis points from late-1990 levels—putting 30-year fixed-rate mortgages around 9.50 percent—and short-term rates dropping by a bit more.

The primary reason for the current mild recession—the collapse of consumer confidence stemming from the Iraqi invasion of Kuwait—should begin to be reversed with a resolution of that conflict. Although lower mortgage rates will help the housing market, the current slow housing market has not been caused by excessively high mortgage rates. As a result, a significant rise in home sales and construction is not likely to occur unless potential buyers are more confident about their future employment and income prospects—which is unlikely to occur without a favorable resolution to the crisis in the Middle East.

This rise in consumer sentiment, combined with lower interest rates, is expected to allow the housing market to begin recovering by the second quarter. Home sales should recover first—with new home sales climbing to about a 585,000 annual rate by the fourth quarter and existing home sales going up to 3.42 million units. For the year as a whole, home sales should be close to their 1990 levels. Builders are likely to lag the increase in sales, however, particularly for multifamily structures. Difficulties in financing multifamily projects, combined with still-high vacancy rates, will keep multifamily construction in the dumps for at least the year ahead.

Single-family construction is expected to begin to pick up after the rise in new home sales becomes more pronounced, but difficulties in obtaining loans for acquisition, development and construction—as well as builder caution—are likely to keep single-family starts at relatively low levels. As a result, total housing starts for 1991 should be down by about 6 percent from 1990, although we expect them to get steadily stronger as the year progresses.

TABLE 1

Households and Household Growth
(thousands)

	Total Households	Average Annual Increase Over Previous Decade
1960	52,799	925
1970	63,403	1,060
1980	80,776	1,737
1990	94,562	1,379
2000	106,612	1,205

The economy is likely to begin this year in the same fashion that it ended the last one—in a mild recession.

Fannie Mae's forecast of mortgage originations for 1991 is somewhat more optimistic than MBA's, with home sales and price projections that are slightly stronger. The drop in mortgage rates during the first half of 1991 also should allow an increase in refinancing activity throughout much of the year. As a result, we expect one- to four-family mortgage originations to climb by about 3 percent over 1990's level—which should end up slightly below the level of 1989.

The long-term outlook

In determining the outlook for housing and mortgage markets during the next decade, more than a simple forecast of economic and housing demand is required. Over the long run, demographics and productivity growth largely control the housing market—combined with public policy changes affecting tax policy and land use. During the next decade, two events should dominate demographic changes in the United States: a slowdown in population growth and the passing of the "baby boom" generation—those born between 1946 and 1964—into middle age. According to the Census Bureau, the total population of the U.S. is projected to increase by only 0.7 percent annually in the next decade, compared with growth rates of 1.1 percent in the 1970s and 1.0 percent between 1980 and 1989.

Significant changes in the composition of the population are expected to accompany this slowdown in population growth. The proportion of adults in the 25 to 34 age group swelled from 12.3 percent in 1970 to 17.9 percent in 1988. In the 1990s, much of this demographic bulge will move into the 35 to 44 age bracket. By 2000, all of the baby boomers will be above the age of 35. As a result, the share of the total population between the ages of 35 to 44 will rise steadily from 13.3 percent in 1985 to 16.6 percent in the year 2000.

Household growth is also expected to slow in the 1990s. This will result not only from slower population growth, but also from smaller increases in headship rates, that is, the number of heads of households in the country. On balance, headship rates in the next decade are projected to increase modestly for the baby boom generation (age 35 to 54), with smaller increases projected for the 25 to 34 and 65-and-over age groups. The headship rate for the 55 to 64 age group is expected to show no change, while the rate for the under-25 age group is expected to show a small decline.

Combined with the changing age structure of the population, this projection of headship rates produces an annual average increase in households of about 1.2 million (see Table 1). By contrast, household formation surged to a record annual average of more than 1.7 million in the 1970s as the baby boom generation began to reach adulthood. Household growth slowed in the 1980s, although it remained strong by historical standards. Still, household growth is estimated to have slowed by more in the 1980s than it should in the 1990s.

For analyzing housing demand, it can be useful to group households by traditional first-time homebuyers (heads of households under 35 years), moveup households (35 to 54 years), and older households (55 years and above). Between 1970 and 1980, the number of first-time households increased sharply, and their share of total households grew to 31 percent. Between 1980 and 1990, the share of moveup households will have increased as the leading edge of the baby boom enters this age group. The share of moveup households should grow even more dramatically by the year 2000 (see Table 2).

Clearly, the moveup households will be increasing their demand for housing—given the state of the economy—over the 1990s. During the same period, however, the first-time households will be actually shrinking; lessening the demand for starter homes. How will the moveup buyers be able to sell their homes to first-time buyers if the population of first-time buyers is shrinking?

Part of the answer to this should come from pent-up demand for starter homes coming from baby boomers. Homeownership rates fell consistently from 1980 to 1985, and have remained nearly unchanged since then. It has been the under-40 age group that has suffered the biggest decline in homeownership rates over this period, primarily for affordability reasons. If homeownership rates for this group increase in the 1990s—as they move into age brackets that typically have higher homeownership rates, as their incomes increase from moving up the career ladder and as real mortgage rates decline and real home price appreciation slows (see the following)—then much of the decline in first-time buyer demand among younger households may be offset.

For example, if the 1976 homeownership rates for the 25 to 45 age groups had prevailed in 1988, there would have been an additional 2.6 million homeowners. The increase would still be large—1.0 million—if the base year chosen was 1983, by which time homeownership rates for younger households had fallen significantly.

Although the economy may be described well in the short-term by its demand characteristics, over the longer-term it is the economy's supply side that largely determines such things as growth and inflation. The supply side of the U.S. economy is determined primarily by the inputs to the production process—land, labor and capital—as well as the efficiency with which those inputs are used, measured by productivity.

Fannie Mae's projections of population and household growth suggest that growth of the labor force is likely to slow in the 1990s, implying that employment growth will also slow. Unfortunately, this slowing of employment growth will be compounded by continued slow productivity gains as a result of historically low levels of net business fixed-investment in the 1980s and an educational system that has slipped, compared with other nations. This slow productivity growth will

TABLE 2

Composition of Households
(thousands)

	1970	1980	1990	2000
First-time (under 35)	16,053 (25%)	25,073 (31%)	26,057 (28%)	22,759 (21%)
Moveup (35 to 54)	24,026 (38%)	26,634 (33%)	35,700 (37%)	47,100 (44%)
Older (over 55)	23,324 (37%)	29,069 (36%)	32,805 (35%)	36,753 (35%)

Note: Percentages represent shares of the total population in each year.

TABLE 3

Economic Figures: History and Projections

	1950-1960	1960-1970	1970-1980	1980-1990	1990-2000
Annualized Percent Change in:					
Real GNP	3.3%	3.8%	2.8%	2.9%	2.7%
GNP Deflator	2.6%	3.1%	7.4%	4.4%	4.0%
Productivity	2.1%	2.4%	1.1%	1.4%	1.6%
Annual Averages:					
10-Year Treasury	3.4%	4.9%	7.9%	10.3%	7.0%
Mortgage Rate	—	6.7%	9.2%	11.5%	9.3%
Unemployment Rate	4.6%	4.8%	6.3%	7.1%	4.9%
Employment Growth	901	1,671	1,953	2,058	1,870

TABLE 4

Home Sales and Starts
(thousands)

	New Sales	Total Starts	Existing Sales
1970-1980	661	1,750	2,885
1980-1990	618	1,500	3,070
1990-2000	575	1,250	3,550

TABLE 5

Changes in Median Home Prices

	New Homes		Existing Homes	
	Nominal	Real	Nominal	Real
1970-1980	10.7%	3.3%	10.5%	3.2%
1980-1990	6.5%	2.1%	4.5%	0.1%
1980-1985	5.5%	0.2%	4.0%	−1.3%
1985-1990	7.5%	4.0%	5.0%	1.4%
1990-2000	6.6%	2.5%	3.8%	−3.2%

TABLE 6

Single-Family Mortgage Originations, Annual Averages
($ billions)

	Purchase Originations	Refinancings	Total
1970-1980	101.1	12.6	113.6
1980-1990	217.5	68.3	285.8
1990-2000	408.4	72.1	480.5

mean that real GNP growth in the coming decade will be below average (see Table 3).

Despite relatively low economic and productivity growth, the rate of inflation should be somewhat slower in the 1990s than during the past 10 years. Much of the inflation in the 1970s and early 1980s was due to Federal Reserve reaction to supply shocks—with an expansionary monetary policy initially monetizing the rise in energy prices. The current oil shock indicates that the Fed will not respond to rising energy prices as it did in the past, keeping the basic thrust of monetary policy an anti-inflationary one. In addition, the federal budget deficit should decline in the 1990s, particularly as a share of output. Furthermore, increased international competition, as U.S. trade expands, will make it more difficult with time for domestic firms to increase prices beyond the rate of productivity growth.

Lower inflation should bring a reduction in inflation expectations and a decline in real interest rates. Combined with the drop in expected inflation should be lower federal government borrowing needs, as the budget deficit declines as a share of GNP—especially with rising social security surpluses. In addition, modest increases in personal savings as the U.S. population ages should help to reduce real interest rates. Taking all of these influences together, long-term interest rates should decline by about 350 basis points during the current decade compared with their average in the 1980s—bringing the rate on 10-year Treasuries down to about 7.0 percent, or about 125 basis points below current levels.

Mortgage rates should share in this drop, but to a somewhat lesser extent. Increased levels of mortgage and mortgage-backed security sales in the 1990s as a result of FIRREA will likely widen the spreads between mortgages and Treasuries from current levels—although this widening should not be substantial. As a result, 30-year fixed-rate mortgages should average a bit above 9.0 percent in the coming decade.

We expect one- to four-family mortgage originations to climb by about 3 percent over 1990's level—which should end up slightly below the level of 1989.

Primarily as a result of the decrease in net household formation, housing starts should decline in the 1990s compared with the 1980s. In addition, the absolute decline in younger households is expected to result in a shift away from both mobile homes and multifamily rental properties. Given the forecast of 1.2 million new households per year, new housing units of about 1.45 million per year will be needed. Since about 200,000 units of that need will be met by mobile homes, down from 250,000 in the 1980s, starts will yield about 1.25 million.

The split between single-family and multifamily starts will move more to favor single-family construction during the current decade given the decline in younger households—who typically rent—and the still-large inventory of vacant multifamily rental units. Taking this into account, multifamily starts of about 310,000 per year should occur in the 1990s, compared with annual averages of more than 600,000 in the 1970s and about 500,000 in the 1980s. The remainder of the needed housing units will be single-family, yielding a projection of average annual single-family starts of 940,000. That compares with almost 1.15 million single-family starts in the 1970s and about 1 million in the 1980s.

Because a portion of single-family home construction is contract built (and so is never counted as a home sale,) new home sales are less than starts. In the absence of any significant long-term variation in the 1980s average of new home sales, averaging just under 62 percent of single-family starts, the 1990s average should be similar. This would yield new home sales of about 575,000 for the current decade, compared with 618,000 in the 1980s and 661,000 in the 1970s. The ratio of moveup homes to starter homes will likely be much higher in the 1990s than in the 1980s as the baby boom cohort moves into middle age. This should result in an increase in the number of new homes sold to moveup buyers despite a drop in overall new home sales due to fewer first-time buyers.

Existing home sales depend most heavily on the number of households in the long run, with changes in economic growth and interest rates influencing year-to-year sales. Lower mortgage rates on average in the 1990s, as well as somewhat faster economic growth (coming primarily from no deep recessions such as 1981-82) should result in an increase in the resales-to-households ratio. The drop in younger households, however, should just about offset the impact of mortgage rates and economic growth. As a result, the ratio of existing home sales to households in the 1990s is expected to be about the same as in the 1980s—3.5 percent. This leads to a rising projection for existing home sales as the absolute number of households rises. For the 1990s as a whole, existing home sales should average about 3.55 million per year, compared with 3.07 million in the 1980s and 2.89 million in the 1970s (see Table 4).

Home prices over the coming decade will depend upon the relative demand and supply for homes, as well as changes in the mix of homes sold. The demand for housing depends upon the number of households, income growth, interest rates and consumer preferences. Slower income growth during the decade resulting from modest real GNP gains and rising income flows going abroad due to the accumulation of trade deficits in the 1980s and 1990s, as well as lower net household formation, should act to slow housing demand. On the other hand, lower real mortgage rates will add to housing demand by improving affordability. In addition, the demand for relatively more expensive trade-up homes will increase with an aging population.

The supply of housing is determined by an array of costs, including labor, materials, land and regulation. Since 1960, both labor and lumber costs have increased at about the same rate as the consumer price index, and there is no reason to expect any change from this pattern in the 1990s. Land costs, however, are estimated to have risen about twice as fast as inflation. Slower demand for housing should reduce land price appreciation, although an increase in the demand for second-homes by an aging population may partially offset this. Regulatory costs involve building codes and standards, lot requirements, impact and transfer fees, zoning ordinances and other growth limits and land-use restrictions.

These regulatory costs give every indication of rising at an increasing rate in the 1990s. Areas of high population density, particularly where limits have been imposed on general real estate taxes, have already begun turning to taxes on new construction and transfer of ownership to offset infrastructure costs.

On balance, home prices should rise more slowly in this decade than in the last one. New home prices should continue to rise faster than inflation as a result of rising demand for trade-up homes and increasing supply costs for housing. Existing home sales, however, are likely to rise at about the rate of inflation, as supply cost increases will impact existing homes only with time as new homes in the 1990s become resales. In addition, the decline in younger households will slow demand. As a result, the gap between median prices of new and existing homes should continue to grow (see Table 5).

From these projections of the economy and the housing market, we can estimate the volume of single-family mortgage originations. Originations can be broken down into loans for home purchases, purchase originations and refinancings. The volume of purchase originations during the 1990s is based on the dollar volume of single-family home sales, which follows from the forecasts of home sales and prices just given. With mortgage rates in the 1990s not projected to reach the extreme levels of the early 1980s—and also not dropping as they did in the mid-1980s—refinancings can be expected to average about 15 percent of total originations, significantly less than the almost 24 percent level of the 1980s (see Table 6). Note that these figures are based on the old survey of mortgage originations by HUD. In January 1990, HUD changed its survey methodology in a way that has made the origination figures before 1990 not strictly comparable to the new figures. To get an estimate of the size of the change, 1990 originations are estimated to be about $412 billion using the new survey methodology—but only about $350 billion using the old methodology.

In conclusion, the housing market during the 1990s should be better than it will be in 1991. The mild recession that we are currently in, which we expect will last for about six months, will act to keep the housing market in its depressed state until the middle of this year. For the year as a whole, the housing market in 1991 will resemble 1990. For the decade as a whole, however, lower real interest rates, more affordable housing, and increased home buying by baby boomers should offset much of the impact of slower population growth and household formation. **MB**

David W. Berson is vice president and chief economist of Fannie Mae in Washington, D.C.

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VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHFB			FNMA		FHLMC	
1990	FHA New Homes[1]	CONVENTIONAL[2] FRM	CONVENTIONAL[2] ARM	Median Cost of Funds SAIF Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
AUG	10.20%	10.33%	9.18%	7.66%	7.96%	10.00%	8.35%	10.10%
SEP	10.26	10.33	9.06	NA	7.96	10.07	8.28	10.18
OCT	10.24	10.37	9.03	NA	7.84	10.08	8.20	10.17
NOV	**NA**	**NA**	**NA**	**NA**	**7.60**	**9.87**	**8.08**	**9.90**

SELECTED SECURITIES

			U.S. GOVERNMENT				
1990	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
AUG	8.13%	7.88%	7.38%	7.78%	8.22%	8.75%	10.29%
SEP	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV	**7.81**	**7.91**	**7.03**	**7.31**	**7.74**	**8.39**	**10.07**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1990	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
AUG	9.80%	9.75%	9.75%	105	100	100
SEP	9.86	9.79	9.73	97	90	84
OCT	9.84	9.80	9.69	112	108	97
NOV	**9.57**	**9.54**	**9.48**	**118**	**115**	**109**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA				FHLMC*				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1990	Commitments**	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
JUL	$2,215	$2,304	$268,052	$6,869	$4,507	$5,851	$4,527	$4,247	$8,553	$5,551
AUG	2,302	2,134	275,227	9,378	6,279	5,645	5,417	4,808	4,492	6,557
SEP	2,073	2,123	281,806	8,953	4,749	6,643	5,798	5,707	7,094	5,421
OCT	**1,849**	**2,077**	**287,674**	**8,078**	**NA**	**NA**	**NA**	**NA**	**5,748**	**5,346**
1989 TOTAL	27,409	22,518	---	69,764	85,408	86,263	78,589	73,518	62,000	57,323
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	60,009	55,285
10 MONTH AVG. 1990	1,916	1,947	---	8,049	5,886	7,592	5,753	5,761	5,553	5,386
1989	2,238	1,716	---	5,091	6,409	6,660	6,037	5,645	4,753	4,617
1988	2,080	1,979	---	4,404	3,280	5,122	3,343	2,929	4,953	4,648

*FHLMC year to date averages are for nine months.

**Does not include standby commitments issued, but includes standby commitments converted.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUL	1,158	904	249	1,082	838	244	113	225	493	322	111	227	428	316
AUG	1,131	866	265	1,050	818	232	120	241	434	336	112	225	402	311
SEP	1,107	897	210	992	786	206	104	242	441	320	104	221	386	281
OCT	**1,041**	**885**	**156**	**925**	**754**	**171**	**144**	**236**	**395**	**266**	**115**	**198**	**358**	**254**
1989 TOTAL	1,376	1,059	318	1,338	999	340	179	266	536	396	179	252	505	402
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
10 MONTH AVG. (SAAR)														
1990	1,241	975	266	1,160	885	275	138	267	488	348	132	258	437	334
1989	1,402	1,075	327	1,342	1,002	340	188	268	549	397	185	259	507	389
1988	1,477	1,134	343	1,442	1,061	381	246	266	567	399	238	261	538	407

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
JUL	3,330	2,570	9.3	541	351	7.9
AUG	3,500	2,720	9.3	530	345	8.0
SEP	3,170	2,590	9.8	509	339	8.3
OCT	**3,020**	**2,580**	**10.3**	**491**	**334**	**8.4**
1989 TOTAL	3,440	—	—	650	—	—
1988 TOTAL	3,594	—	—	676	—	—
10 MONTH AVG. (SAAR)						
1990	3,330	—	—	547	—	—
1989	3,518	—	—	653	—	—
1988	3,448	—	—	678	—	—

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

1990	Total[5]	1-Unit	2+ Units	Nonresidential
JUL	$300.8	$100.0	$16.9	$99.0
AUG	293.0	97.6	16.9	94.1
SEP	289.1	95.2	16.7	93.0
OCT	**286.9**	**93.5**	**17.0**	**92.4**
1989 TOTAL	308.5	108.3	20.7	96.0
1988 TOTAL	314.4	112.0	21.4	93.5
10 MONTH AVG. (SAAR)				
1990	302.0	104.1	17.7	94.8
1989	310.9	109.3	21.0	96.4
1988	314.4	111.7	21.0	93.6

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1990															
MAR	$35,273	$8,703	$12,700	$13,460	$29	$2,970	$557	$1,113	$1,014	$61	$19,167	$102	$804	$15,172	$2,978
APR	35,407	7,543	12,400	15,122	28	1,973	145	935	698	50	18,984	100	621	14,796	3,048
MAY	37,255	9,420	13,183	14,231	27	2,453	297	1,061	874	39	15,412	110	640	10,905	2,657
JUN	**39,247**	**9,714**	**14,028**	**15,063**	**29**	**2,938**	**209**	**1,149**	**682**	**182**	**16,429**	**105**	**684**	**12,303**	**3,097**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85,307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
6 MONTH AVG.															
1990	35,717	9,175	12,245	13,869	65	2,826	459	987	865	210	16,946	128	704	12,695	3,039
1989	27,827	5,346	12,838	9,247	77	2,512	271	1,245	572	174	10,949	104	1,458	7,551	1,703
1988	30,100	6,952	14,239	8,375	187	2,793	304	1,569	515	245	15,148	50	2,037	10,829	2,006

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
JUN	150	90	17	43	112	$9,010	64	$4,289	16	$1,309	32	$3,412
JUL	144	84	15	45	118	9,651	67	4,509	15	1,253	36	3,889
AUG	154	89	18	47	126	10,273	70	4,764	19	1,572	37	3,937
SEP	**119**	**68**	**14**	**37**	**109**	**8,827**	**64**	**4,319**	**14**	**1,180**	**31**	**3,328**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
9 MONTH AVG.												
1990	144	86	17	41	114	8,993	66	4,386	17	1,337	31	3,270
1989	143	85	16	42	102	7,715	57	3,581	15	1,145	30	2,989
1988	153	84	17	52	112	8,187	59	3,544	17	1,298	36	3,345

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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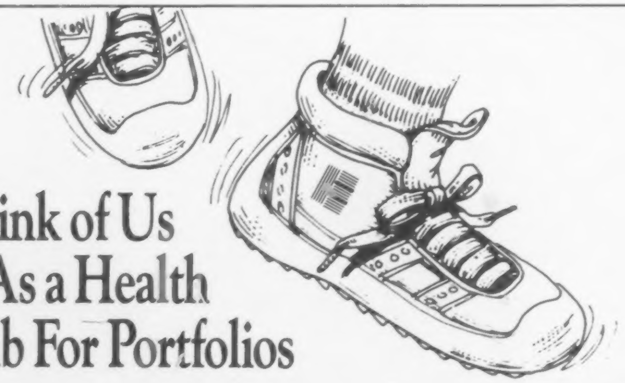
I certify that the statements made by me are correct and complete.

Janet Reilley Hewitt



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FEBRUARY 1991

MORTGAGE BANKING

THE MAGAZINE
OF REAL ESTATE
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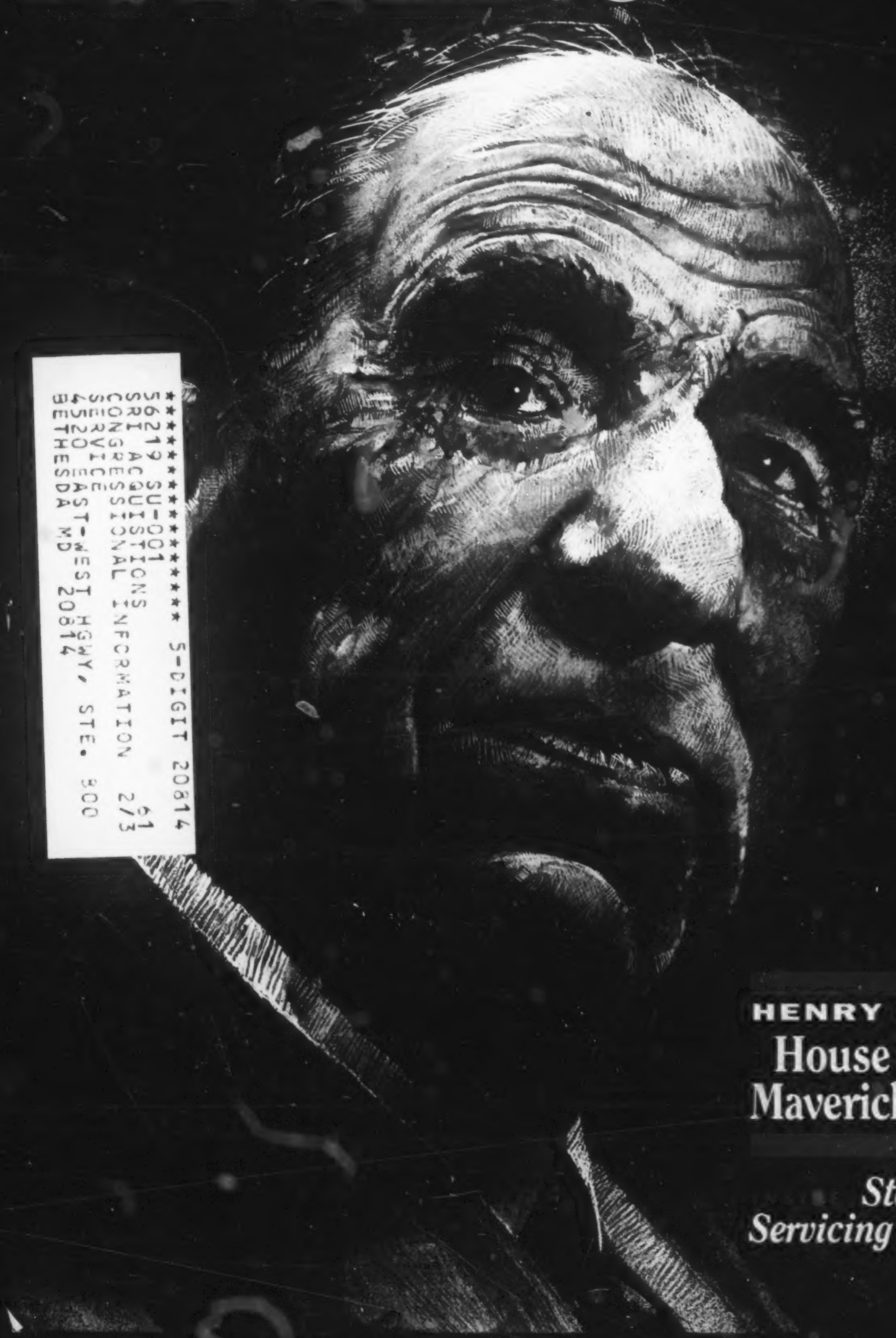

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HENRY GONZALEZ

House Banking's Maverick Chairman

State of the Art Servicing Management

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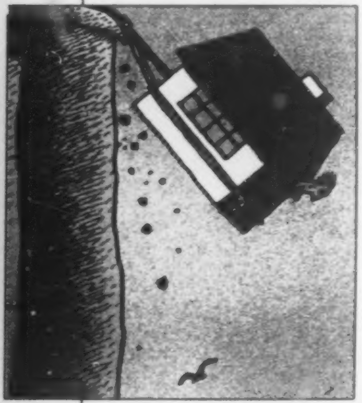
FEBRUARY 1991 VOLUME 51 NUMBER 5

COVER: The nation's banking laws are on the brink of dramatic change. The Depression era laws have been out-of-step with financial services reality for quite some time. With the banks' deposit insurance fund now wobbly in the face of recession, the time has come for Washington to address the issue. The man of the hour is a one-of-a-kind Democrat from Texas who heads the House Banking Committee. Henry Gonzalez will play a unique role, along with his Senate counterpart, in shaping the new rules of the game.

Servicing Management

11 Foreclosure Combat *Pulling savable loans from the brink of foreclosure is good business. With delinquencies rising, here are some tips on how to make this strategy work.* By CAM MELCHIORRE



21 Servicing in a Slump *In 1985, there were few, if any, adverse consequences for defaulting borrowers. But servicers have learned a lot since the oil patch housing recession.* By GENE CAMPION

27 Maximizing Manpower *Highly trained personnel, supplied with the best technology, are the keys to better productivity in servicing.* By TIMOTHY L. RECTOR

33 Match Game *It takes a matchup of buyers and sellers to keep servicing prices from plummeting. With the RTC weighing down the market on the sell side, it looks like a buyer's market. But, many traditional buyers of servicing are looking for quality, regionally specific portfolios that RTC simply doesn't have to sell.* By HOWARD SCHNEIDER

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38 The Spicy Politics of Henry Gonzalez *The Texas maverick who heads the House Banking Committee defies political labels. This first part of a two-part series profiles Chairman Gonzalez—a man in the uniquely powerful position to rewrite the nation's banking laws.* By ROBERT STOWE ENGLAND

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COVER ILLUSTRATION BY WEB BRYANT

PORTFOLIO

Servicing's Nemesis

Housing depreciation and economic downturns are things that servicers have learned to dread. But they are also facts of life in the housing business. Smart servicers have learned that it is no longer permissable to be without an aggressive plan and effective tools for surviving these inevitable downturns. The costs are simply too great.

So, not surprisingly, in 1991, the industry is turning back to the chapter written about the last deep regional housing crisis in the oil patch, and pulling pages out of the book to help manage the way through the current downturn. The goal is to leave as few casualties as possible—and that means keeping REO and foreclosures to the absolute minimum.

The oil patch recession left a legacy of familiar stories about borrowers simply mailing in their keys. The REO losses produced by that severe downturn are still vivid memories for many in the business—and for some now out of the business. Those caught in the spiral of the oil industry's decline saw borrowers—with little to lose—casting aside legal obligations to pay back loans and simply defaulting with the intent to buy new homes, often in the same neighborhood, at the much-improved going rate.

But our authors describe how at least some of the rules of that game have changed. The stakes have been raised for the te[illegible] borrower—with defaults now almost a sure bet to end up on a credit r[illegible]

New England is the spot now on the industry's m[illegible] for a replay of these unpleasant circumstances. This month in our cover report we have packaged some expert advice on how to avoid foreclosures and work with borrowers to mitigate losses in stalled housing markets. The issue also covers how computer systems and other advanced technology are transforming the servicing workplace for the better. Servicing productivity and performance stand to benefit from the widespread adaptation of technology in the business. Last but not least, this month's issue carries the first of a two-part profile of a lawmaker with the fervor of a political missionary. Meet House Banking Committee Chairman Henry Gonzalez and get an inkling of what might happen when the nation's banking laws are revisited.

Janet Reilley Hewitt
Editor in Chief

EDITOR'S NOTE: In an article in the December issue titled "A Slow Start for Reverse Mortgages," on page 39, Donald Redfoot was misidentified as a HUD lobbyist. Mr. Redfoot is a legislative representative for the American Association of Retired Persons.

COMING IN MARCH

Exploring automation in all aspects of the business is the assignment for next month. We will explore the systems that mortgage insurers, Fannie Mae, Freddie Mac, HUD and lenders are using to keep a watchful eye on how loans are performing, how originators are underwriting and how seller/servicers are doing.

MORTGAGE BANKING
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VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHFB			FNMA		FHLMC	
1990	FHA New Homes[1]	CONVENTIONAL[2] FRM	CONVENTIONAL[2] ARM	Median Cost of Funds SAIF Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
SEP	10.26%	10.33%	9.06%	NA	7.96%	10.07%	8.28%	10.18%
OCT	10.24	10.37	9.03	NA	7.84	10.08	8.20	10.17
NOV	10.02	10.39	9.07	NA	7.60	9.87	8.08	9.90
DEC	**NA**	**NA**	**NA**	**NA**	**7.34**	**9.56**	**7.93**	**9.67**

SELECTED SECURITIES

			U.S. GOVERNMENT				
1990	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
SEP	8.20%	7.96%	7.32%	7.76%	8.27%	8.89%	10.28%
OCT	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC	**7.31**	**7.80**	**6.70**	**7.05**	**7.47**	**8.08**	**9.95**

CURRENT SECONDARY MARKET YIELDS

1990	GNMA[3]	FNMA[3]	FHLMC[3]
SEP	9.86%	9.79%	9.73%
OCT	9.84	9.80	9.69
NOV	9.63	9.66	9.54
DEC	**9.22**	**9.27**	**9.16**

SPREADS

(Basis Points)

1990	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
SEP	97	90	84
OCT	112	108	97
NOV	124	127	115
DEC	**114**	**119**	**108**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC*				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1990	Commit-ments**	Pur-chases	Out-Standing	Issued	Commit-ments To Sell	Commit-ments To Buy	Mort-gages Pur-chased	PCs Issued	Appli-cations	Issued
AUG	$2,302	$2,134	$275,227	$9,378	$6,279	$5,645	$5,417	$4,808	$4,492	$6,557
SEP	2,073	2,123	281,806	8,953	4,749	6,643	5,798	5,707	7,094	5,421
OCT	1,849	2,077	287,674	8,078	7,280	10,972	6,118	5,734	5,748	5,346
NOV	**2,426**	**2,078**	**293,710**	**8,199**	**NA**	**NA**	**NA**	**NA**	**5,008**	**5,889**
1989 TOTAL	27,409	22,518	---	69,764	85,408	86,263	78,589	73,518	62,000	57,323
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	60,009	55,285
11 MONTH AVG. 1990	1,962	1,959	---	8,062	6,025	7,930	5,790	5,758	5,504	5,432
1989	2,265	1,776	—	5,421	6,721	6,750	6,222	5,786	4,680	4,723
1988	2,008	1,944	—	4,495	3,350	5,051	3,412	3,003	5,099	4,634

*FHLMC year to date averages are for ten months.

**Does not include standby commitments issued, but includes standby commitments converted.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
AUG	1,131	866	265	1,050	818	232	120	241	434	336	112	225	402	311
SEP	1,106	893	213	992	786	206	104	239	445	318	104	221	386	281
OCT	1,033	877	156	920	751	169	142	237	394	260	113	200	354	253
NOV	**1,129**	**815**	**314**	**907**	**713**	**194**	**140**	**237**	**478**	**274**	**103**	**200**	**365**	**239**
1989 TOTAL	1,376	1,059	318	1,338	999	340	179	266	536	396	179	252	505	402
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
11 MONTH AVG. (SAAR)														
1990	1,230	959	271	1,136	869	267	138	264	487	340	129	253	430	325
1989	1,397	1,073	324	1,344	1,006	338	187	270	545	394	183	258	506	397
1988	1,484	1,140	344	1,448	1,064	384	243	266	571	404	234	258	541	415

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
AUG	3,500	2,720	9.3	527	345	8.1
SEP	3,170	2,590	9.8	507	339	8.3
OCT	3,050	2,640	10.4	492	334	8.3
NOV	**3,140**	**2,590**	**9.9**	**506**	**327**	**7.8**
1989 TOTAL	3,440	—	—	650	—	—
1988 TOTAL	3,594	—	—	673	—	—
11 MONTH AVG. (SAAR)						
1990	3,315	—	—	543	—	—
1989	3,458	—	—	656	—	—
1988	3,527	—	—	675	—	—

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

1990	Total[5]	1–Unit	2+ Units	Nonresidential
AUG	$286.1	$97.6	$16.9	$93.2
SEP	290.5	95.1	16.7	91.9
OCT	282.7	93.7	17.0	89.1
NOV	**277.0**	**91.6**	**16.3**	**87.3**
1989 TOTAL	308.5	108.3	20.7	96.0
1988 TOTAL	314.4	112.0	21.4	93.5
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LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit
(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[5]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1990 APR	$35,407	$7,543	$12,400	$15,122	$28	$1,973	$145	$935	$698	$50	$18,984	$100	$621	$14,796	$3,048
MAY	37,255	9,420	13,183	14,231	27	2,453	297	1,061	874	39	15,412	110	640	10,905	2,657
JUN	38,428	9,714	13,209	15,063	29	2,778	209	989	682	182	16,411	105	666	12,303	3,097
JUL	**35,519**	**9,627**	**12,015**	**13,461**	**30**	**2,082**	**165**	**871**	**696**	**209**	**16,221**	**98**	**475**	**12,525**	**2,984**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85,307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
7 MONTH AVG. 1990	35,572	9,239	12,095	13,811	60	2,697	417	948	841	210	16,840	124	669	12,670	3,032
1989	27,706	5,372	12,619	9,315	78	2,388	274	1,170	536	174	11,520	109	1,374	8,160	1,745
1988	30,932	7,057	14,754	8,564	216	2,925	380	1,582	543	263	15,105	61	2,034	10,835	1,958

MORTGAGE INSURANCE
(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE*	TOTAL		FHA		VA		PRIVATE*	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
JUL	144	84	15	45	118	$9,651	67	$4,500	15	$1,253	36	$3,889
AUG	154	89	18	47	126	10,273	70	4,764	19	1,572	37	3,937
SEP	119	68	14	37	109	8,827	64	4,319	14	1,180	31	3,328
OCT	**NA**	**74**	**20**	**NA**	**NA**	**NA**	**66**	**4,476**	**19**	**1,612**	**NA**	**NA**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
10 MONTH AVG. 1990	NA	85	17	41	NA	NA	66	4,395	17	1,365	31	3,270
1989	NA	85	16	42	NA	NA	59	3,702	15	1,153	30	2,989
1988	NA	83	18	52	NA	NA	60	3,654	18	1,307	36	3,345

* Private insurance year-to-date averages are for nine months.

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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MARCH 1991

MORTGAGE BANKING

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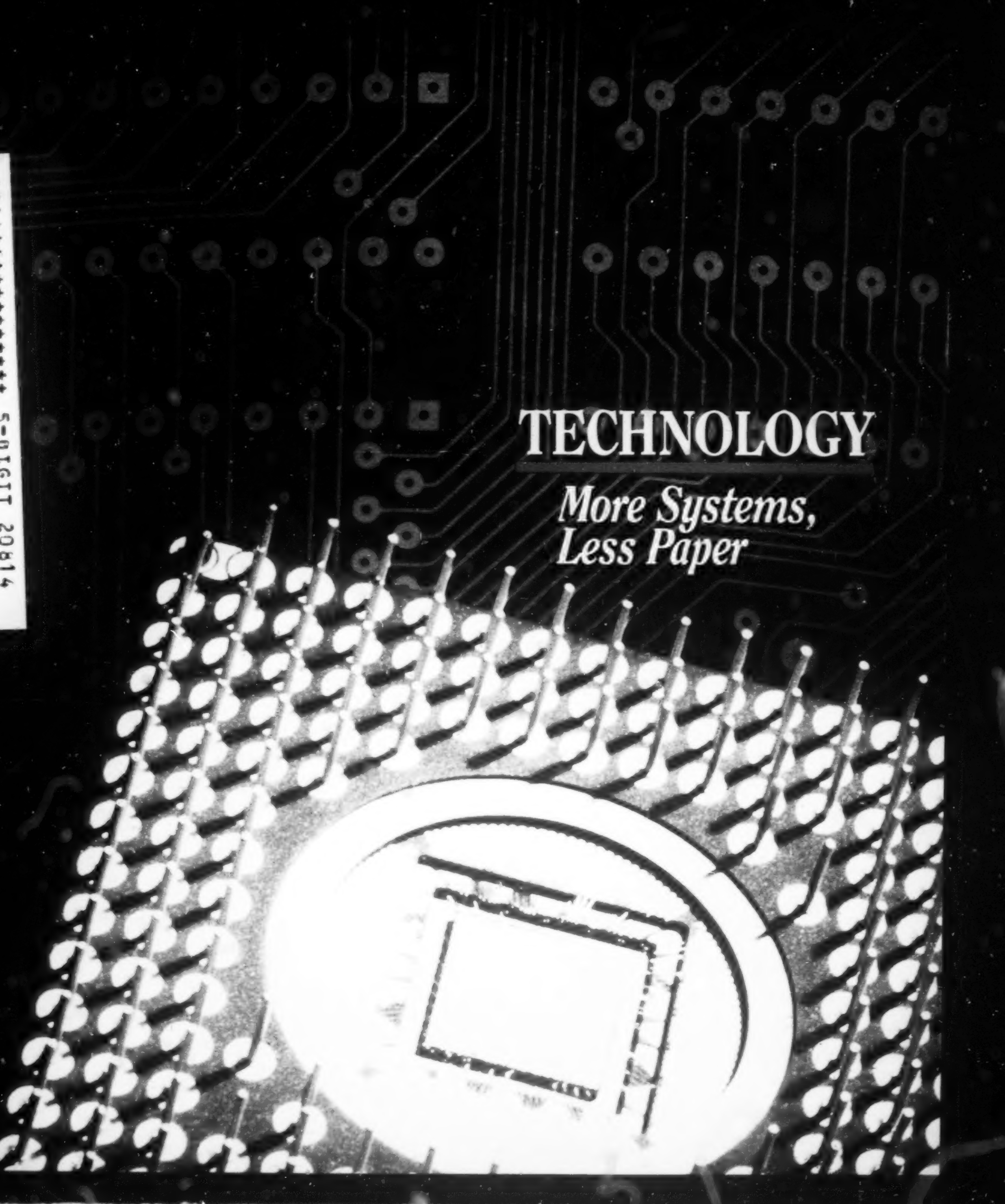

TECHNOLOGY

More Systems, Less Paper

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MARCH 1991 VOLUME 51 NUMBER 6

COVER:
Automation

Computer applications are multiplying in every corner of the mortgage business. If there was ever an industry tailor-made for all types of high technology, mortgage banking is it. Lenders are rapidly adapting to this new environment where technology is making things happen faster than ever before. And information is becoming available that will build better decision making into a permanent cornerstone of the business.

10 The MI Technology Race *The major mortgage insurers are all investing heavily in technology. They've got their sights set on gaining a competitive edge down a path that promises faster service and better risk assessment.* By HOWARD SCHNEIDER

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23 Portraits of Technology *Envisioning the future is never easy—especially in the realm of high-tech mortgage systems. Here, four companies paint the pictures of success they have achieved by strategically implementing technology.* By BRIAN HERSHKOWITZ

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COVER PHOTOGRAPH BY LARRY KEENAN ASSOC./THE IMAGE BANK

Paper Is Down, But Not Out

Automation has become a pervasive byproduct of man's innovative spirit in the 20th century. Many businesses have leaped at the chance to trade in old tech for high tech. But many businesses are not built around paper to their very core in the fundamental way that mortgage banking is.

The paper of mortgage banking is so treasured— for legal security reasons— that a whole profession has been built up around its care and safekeeping. As the name clearly suggests, document custodians are charged with the important role of seeing, for example, that all the proper paper exists to ensure that mortgages in a Ginnie Mae pool are packaged into securities that legally can carry a government guaranty for investors.

Yet today, even the world of the document custodian—which up until now was a universe stacked with paper—is coming face-to-face with automation. What this will mean for the small and large players who perform the role of document custodians is one of the issues explored this month. Automation, as it moves through every industry, creates winners and losers and initially carries a high price tag. The question is whether small custodial shops will be able to foot the bill for systems, or whether a move to automation will favor those with deep pockets—consolidating this niche business into the hands of a relative few. Another question is whether the government will be a passive or active player in moving custodians toward automation.

An allied industry with the deep pockets and the staff to embrace the goodies that modern technology can offer is the mortgage insurance industry. In this issue we explore what the MIs are doing with artificial intelligence systems and optical disk technology and a few other assorted applications of technology.

Finally, by talking to HUD's, Fannie Mae's and Freddie Mac's technology people, we hoped to get a reading on just how much automation had taken hold in the shops of small and large originators and servicers around the country. As the article reflects, there is still a lot of paper out there—no threat to Federal Express is emerging yet from this industry. But then again, change is rarely delivered overnight.

Janet Reilley Hewitt
Editor in Chief

COMING IN APRIL

The secondary market's success story is the focus for April. The massive growth in this uniquely American investment product and its impressive returns are the focus of expert commentary. We also show you the progress of the MBS as it takes on new markets in Europe and Australia.

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VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHFB			FNMA		FHLMC	
	FHA New Homes[1]	CONVENTIONAL[2]		Median Cost of Funds SAIF Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
1990		FRM	ARM					
OCT	10.24%	10.37%	9.03%	9.67%	7.84%	10.08%	8.20%	10.17%
NOV	10.02	10.39	9.07	9.69	7.60	9.87	8.08	9.90
DEC	9.74	10.20	8.94	9.58	7.34	9.56	7.93	9.67
1991 JAN	**NA**	**NA**	**NA**	**NA**	**7.10**	**9.51**	**7.74**	**9.64**

SELECTED SECURITIES

1990	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT				A-Rated Utility
			6-Month	1-Year	3-Year	10-Year	
OCT	8.11%	7.98%	7.16%	7.55%	8.07%	8.72%	10.23%
NOV	7.81	7.91	7.03	7.31	7.74	8.30	10.07
DEC	7.31	7.80	6.70	7.05	7.47	8.08	9.95
1991 JAN	**6.91**	**7.10**	**6.28**	**6.64**	**7.38**	**8.09**	**9.83**

CURRENT SECONDARY MARKET YIELDS

SPREADS

(Basis Points)

1990	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
OCT	9.84%	9.80%	9.69%	112	106	97
NOV	9.63	9.66	9.54	124	127	115
DEC	9.22	9.27	9.16	114	119	108
1991 JAN	**9.17**	**9.24**	**9.12**	**108**	**115**	**103**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1990	Commitments*	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
SEP	$2,073	$2,123	$281,806	$8,953	$4,749	$6,643	$5,798	$5,707	$7,094	$5,420
OCT	1,849	2,077	287,674	8,078	7,260	10,972	6,118	5,734	5,748	5,347
NOV	2,426	2,078	293,710	8,199	9,948	10,164	6,981	6,314	5,008	5,890
DEC	**2,104**	**2,410**	**299,833**	**8,010**	**7,230**	**12,938**	**10,638**	**9,918**	**4,170**	**4,627**
1990 TOTAL	23,689	23,959	—	96,695	77,412	102,400	75,518	73,815	64,709	64,369
1989 TOTAL	27,409	22,518	—	69,764	85,408	86,263	78,589	73,518	62,000	57,300
12 MONTH AVG. 1990	1,974	1,997	—	8,058	6,451	8,533	6,293	6,152	5,392	5,364
1989	2,284	1,877	—	5,814	7,117	7,189	6,549	6,126	5,167	4,775
1988	1,953	1,926	—	4,573	3,439	5,889	3,673	3,315	5,001	4,607

*Does not include standby commitments issued, but includes standby commitments converted.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
SEP	1,106	893	213	992	786	206	104	239	445	318	104	221	386	281
OCT	1,026	861	165	920	751	169	144	229	393	260	113	200	354	253
NOV	1,127	812	315	906	713	193	142	234	482	269	105	195	367	239
DEC	**987**	**774**	**213**	**846**	**689**	**157**	**112**	**231**	**409**	**235**	**100**	**178**	**337**	**231**
1990 TOTAL	1,193	932	261	1,104	851	253	131	253	480	329	124	235	424	321
1989 TOTAL	1,376	1,059	318	1,338	999	340	179	266	536	396	179	252	505	402
12 MONTH AVG. (SAAR)														
1990	1,209	942	267	1,112	854	258	136	261	482	331	127	246	422	317
1989	1,387	1,066	321	1,343	1,016	327	183	269	536	397	183	267	506	397
1988	1,491	1,145	346	1,454	1,071	383	241	273	574	404	231	258	542	415

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
SEP	3,170	2,590	9.8	505	338	8.4
OCT	3,050	2,640	10.4	475	334	8.6
NOV	3,150	2,580	9.8	496	327	8.0
DEC	**3,220**	**2,070**	**7.7**	**463**	**319**	**8.4**
1990 TOTAL	3,293	—	—	536	—	—
1989 TOTAL	3,440	—	—	650	—	—
12 MONTH AVG. (SAAR)						
1990	3,304	—	—	534	—	—
1989	3,446	—	—	646	—	—
1988	3,594	—	—	677	—	—

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

1990	Total[5]	1–Unit	2+ Units	Nonresidential
SEP	$286.1	$95.1	$16.7	$91.9
OCT	280.9	93.3	17.0	89.1
NOV	273.6	90.6	16.0	86.6
DEC	**271.5**	**88.1**	**16.2**	**87.6**
1990 TOTAL	294.5	100.7	17.4	92.8
1989 TOTAL	308.5	108.3	20.7	96.0
12 MONTH AVG. (SAAR)				
1990	296.0	101.6	17.4	93.8
1989	309.1	108.7	20.7	96.1
1988	314.1	112.1	21.4	93.4

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED

By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1990 MAY	$37,255	$9,420	$13,183	$14,231	$27	$2,453	$297	$1,061	$874	$30	$15,412	$110	$640	$10,905	$2,657
JUN	38,428	9,714	13,209	15,063	29	2,778	209	989	682	182	16,411	105	666	12,303	3,097
JUL	35,519	9,627	12,015	13,461	30	2,082	165	871	696	209	16,221	98	475	12,525	2,984
AUG	**36,651**	**11,236**	**12,937**	**12,032**	**34**	**2,556**	**80**	**950**	**1,243**	**92**	**18,964**	**107**	**647**	**14,783**	**2,994**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85,307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
8 MONTH AVG. 1990	35,707	9,489	12,200	13,588	56	2,680	375	948	891	195	17,106	122	666	12,935	3,027
1989	28,320	5,469	12,828	9,610	83	2,385	281	1,150	549	185	11,709	129	1,339	8,299	1,819
1988	32,044	7,307	15,459	8,702	232	2,995	367	1,634	554	280	15,250	73	2,053	10,922	1,994

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1990 AUG	154	89	18	47	126	$10,205	70	$4,764	19	$1,572	37	$3,869
SEP	119	68	14	37	109	8,827	64	4,319	14	1,180	31	3,328
OCT	133	74	20	39	120	9,756	66	4,476	19	1,612	35	3,668
NOV	**112**	**62**	**14**	**36**	**107**	**8,554**	**63**	**4,225**	**14**	**1,207**	**30**	**3,122**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
11 MONTH AVG. 1990	140	83	17	40	114	9,011	66	4,380	17	1,350	31	3,281
1989	142	84	16	42	106	7,998	61	3,850	15	1,068	30	3,080
1988	149	81	18	50	112	7,881	58	3,552	18	1,309	36	3,335

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

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[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

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COVER:

Secondary Mortgage Market

Car culture is now thoroughly ingrained in American society. Yet the automobile would have remained just an interesting piece of technology—a toy of the monied class—had it not run into a market system that really worked. Packaging goods with great potential demand into affordable purchases is what America does best. The secondary mortgage market is another such innovation that makes the most of the strength of this nation's market economy to bring a higher standard of living to all.

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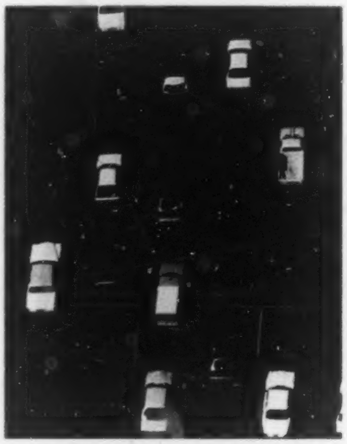
MODEL T COURTESY OF FORD MOTOR COMPANY

PORTFOLIO

Market Perfection

The secondary mortgage market just keeps pursuing perfection. There are many winners benefiting from this ongoing exercise in self improvement. The pricing benefits produced by a well-performing secondary market have been helping average American homeowners every month in the form of lower payments. But investors haven't exactly been forgotten. In seven of the past eight years, the annual total returns on mortgage-backed securities have far exceeded those of Treasury securities.



The numbers clearly document the pricing efficiencies now built into the system. The yield spread on current-coupon Ginnie Maes versus 10-year Treasuries narrowed to just in excess of 100 basis points by the end of last year. That compares with the more than 200 basis point spread that prevailed in early 1983. That is progress.

One of our contributors this month isolates what amounts to a kind of coming-of-age that the secondary market went through dating from about 1983. As the author notes, it is also no mere coincidence that the collateralized mortgage obligation (CMO) was created that year. From 1970 through 1981, the number of originations funded through mortgage-backed securities was a meager share of the total. By 1982, that number started to climb. Between 1983 and 1990, at least 40 percent of originations were funded by pass-throughs, with the exception of two years when ARM volume surged. By last year, a whopping 64 percent of residential originations wound up in securities.

Furthermore, without the help of Fannie Mae, Freddie Mac or GNMA, the jumbo securities market appears to be going gangbusters on its own. Last year, an impressive 40 percent of this production was securitized, up from just 24 percent in 1989.

So, the American secondary market has clearly emerged as a model for funding housing in the most efficient way. Exporting a market concept may sound a bit unwieldy, but going global with the secondary market is clearly the next big chapter to be written.

Janet Reilley Hewitt
Editor in Chief

COMING IN MAY

What's it like to work for a mortgage operation being run by the RTC? We will tell you next month as we tackle a variety of topics on residential lending.

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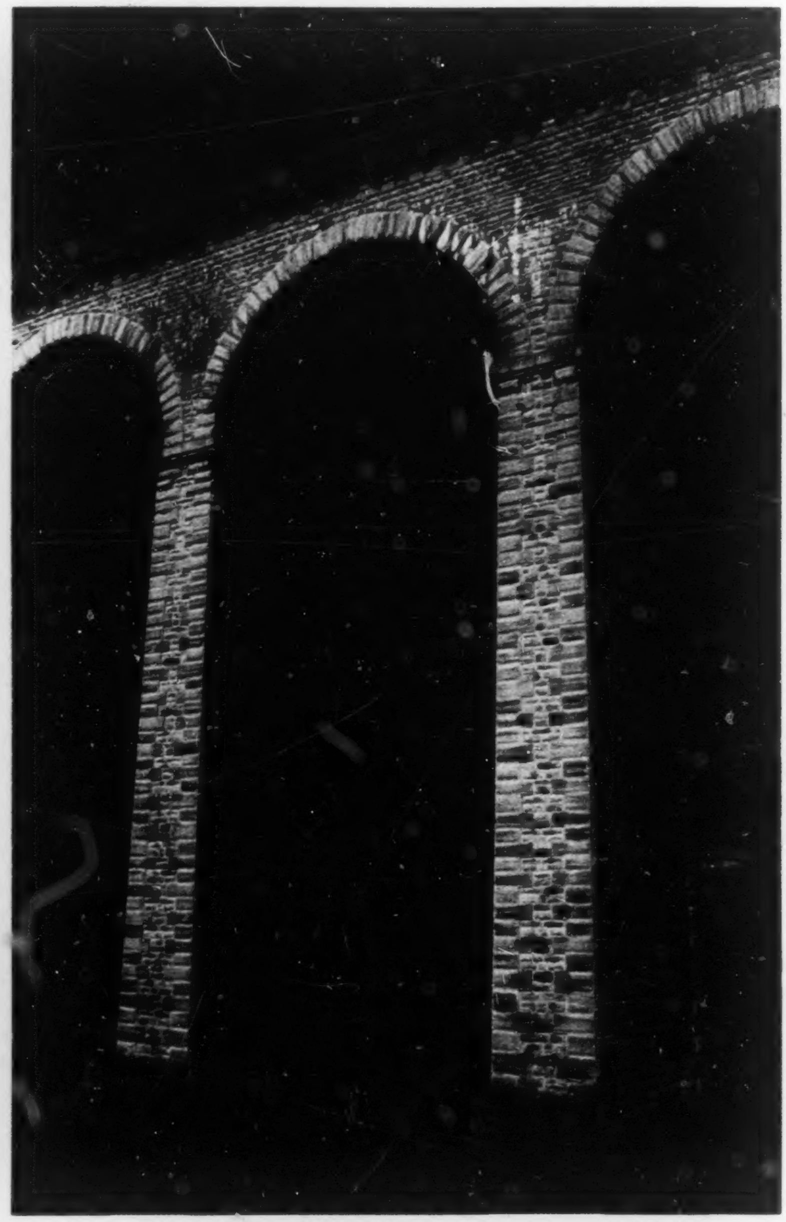


PHOTOGRAPH BY KAY CHERNUSH/THE IMAGE BANK

TESTING THE

Although delinquencies were on the rise in 1990, loans in private pass-throughs were holding up pretty well. Most offerings boast rock-solid credit support to withstand the stress the economy is dishing out.

Howard Esaki

The private residential mortgage pass-through market has recently been marked by increasing concern over the deterioration of credit quality. Falling home prices and a weak national economy have produced rising delinquency and foreclosure rates.

Furthermore, numerous downgrades of financial institutions providing credit support for these offerings have shown that the mortgage pass-through market is not invulnerable to a recession. Indeed, a record number of downgrades of mortgage pass-throughs in the past year confirmed that, similar to the corporate bond market, a weak economy can adversely affect ratings of structured securities.

From the perspective of early 1991, however, Moody's Investors Service believes that the credit support on the vast majority of Aaa-rated and Aa-rated mortgage pass-throughs will far exceed any realized or expected losses on the underlying mortgage collateral in the future.

Credit concerns have produced increased investor appetite for the mortgage securities of Moody's highest rating category. In 1990, more than $10 billion of Aaa-rated mortgage pass-throughs were issued, compared with a total of less than $3 billion in the previous three years (see Table 1). The market has clearly shifted from one of predominately (90 percent) Aa-rated securities during the 1987 to 1989 issuance period to one almost evenly divided between Aa-category and Aaa ratings by 1990.

At the same time that the average rating on the senior class of mortgage pass-throughs was increasing, a record number of junior classes rated below the Aa-category were created by a move toward more complex structures and forms of credit enhancement.

Issuance rises and structures get more complex

Total issuance of publicly rated mortgage pass-throughs rose to a record $25 billion in 1990, up from the $15 billion issued in each of the previous two years.

Issuance of securities backed by home equity lines of credit and second mortgages also increased sharply to $5.6 billion in 1990. That was almost double the volume in 1989 for those securities. Issuance volume was about equally divided between open-ended home equity lines of credit and closed-end second mortgage loans, with the number of separate transactions rising to twenty-five from seven the previous year. More than $5 billion of the securities in the home equity and second mortgage category were rated Aaa.

Total issuance of publicly rated mortgage pass-throughs rose to a record $25 billion in 1990, up from the $15 billion issued in each of the previous two years.

In another sector, CMO issuance increased by about 10 percent in 1990. The increased issuance reflected a rise in mortgage originations and sales by financial institutions under pressure to meet capital requirements.

The share of new, fixed-rate, private pass-through issuance fell from two-thirds in the first half of the year to about 40 percent in the last two quarters. For the year, slightly more than one-half of the issuance was fixed rate, compared to about 45 percent in 1989 and 25 percent in 1988.

Regulatory changes proposed in 1989 continued to exert a strong influence on the form of credit support used for offerings during 1990 and the beginning of 1991. A proposal that issuers retaining a subordinated class hold a large amount of capital against that holding caused a shift away from senior/subordinated structures starting in the last half of 1989. The senior/subordinated structure was used in 80 percent of transactions in 1988, and subordination was the main form of credit support in about one-third of 1990 issues. Another third of 1990 issues derived credit support from pool insurance polices, with the remaining third backed by either letters of credit or corporate guarantees.

The shift away from senior/subordinated structures has led to the evolution of more complex forms of credit support. For example, a "spread account," or the allocation of a portion of the interest payments to credit support, was first used in 1990. The first transaction was issued in March 1990 by Marine Midland Bank, N.A., Buffalo, New York. By April, St. Louis-based Citicorp Mortgage, Inc., was also using spread accounts. In analyzing the value of a spread account, Moody's examines many different prepayment and loss patterns. The faster a pool of collateral prepays, the less cash is built up in the spread account. However, faster prepayments result in a smaller pool of mortgages vulnerable to risk. A positive feature of the spread account is that available credit support is generally greater as the size of the pool grows larger. Many recent transactions have combined several

FOUNDATION

forms of credit support, such as subordination, spread accounts, and/or corporate guarantees. The use of tiered structures with multiple ratings has also increased, as originators attempted to sell subordinated classes in order to lower their capital requirements.

California mortgages dominate

Almost two-thirds of the mortgages in pass-throughs issued in 1990 were originated in California. About 14 percent were from the New York-New Jersey-Connecticut area, and less than 5 percent were from the oil-patch states of Texas, Louisiana and Oklahoma. Private mortgage pass-throughs typically consist of loans with balances exceeding the Fannie Mae/Freddie Mac purchase ceiling, which was raised to $191,250 in 1991 for single-family mortgages, up from $187,450 in 1990.

The average loan-to-value (LTV) ratio for privately securitized loans was 73 percent in 1990. About 10 percent of all loans had an LTV ratio of more than 80 percent, with approximately one-half of this category having private mortgage insurance. Although many lenders were tightening underwriting standards, close to half of the loans packaged into pass-throughs issued during 1990 were originated under some form of limited documentation program.

The average pool issued in 1990 contained loans on investor properties equal to 3 percent of total balances. More than 90 percent of loans in private pass-throughs issued in 1990 were for single-family detached units, with the remainder consisting of condominiums and planned-unit developments. About one-fourth of the loans were equity ("cash-out") refinancings. Most pools securitized in 1990 contained loans with less than a year of seasoning.

Issuance was evenly divided between fixed- and adjustable-rate or graduated-payment mortgages. Nonfixed-rate mortgages consisted of those without negative amortization (19 percent of total issuance), negatively amortizing loans (15 percent), ARMs with a conversion-to-fixed-rate feature (7 percent), graduated payment or growing equity loans (7 percent) and 7-year balloon loans (0.3 percent). In 1989, about one-third of total issuance was ARMs without negative-amortization, with the share for negative amortization ARMs and GPMs at 13 percent and 4 percent, respectively.

In 1990, credit support for Aa2-rated mortgage pass-throughs averaged about 5 percent to 6 percent of the rated amount for fixed-rate securities and 7 percent to 8 percent for ARM pass-throughs. For Aaa-rated securi-

TABLE 1

Ratings of Residential Mortgage Pass-Throughs

	1987-1989 Issuance ($ bil.)	%	1990 Issuance ($ bil.)	%	Total Outstanding[1] (1/31/91) ($ bil.)	%
Aaa	2.8	7.9	10.2	41.5	13.1	25.6
Aa1	0.1	0.3	0.8	3.2	1.3	2.5
Aa2	28.7	79.4	11.7	47.4	31.5	61.6
Aa3	3.9	10.8	1.7	6.9	1.5	2.9
A1	0.4	1.1	*	0.1	0.4	0.7
A2	0.1	0.3	*	**	2.5	4.9
A3	*	0.1	0.1	0.2	0.6	1.3
Baa1	0.0	0.0	*	0.2	*	0.1
Baa2	0.1	0.2	0.1	0.3	0.2	0.4
Baa3	0.0	0.0	*	0.1	*	0.1
Total	42.9	100.0	24.6	100.0	51.1	100.0

* less than $50 million

** less than .05%.

[1] Current balances; includes changes since initial rating.

TABLE 2

Moody's Delinquency Index for Mortgage Pass-Throughs

(Data as of 9/90, from 10/90 distribution date reports)

				Non-performing Loans (%)						
Mortgage Type	Original Balance ($bil.)	Remaining Balance ($bil.)	Remaining Enhancement (as % of pool bal.)	30 Day	60 Day	90+ Day	Total Delinquent	In Foreclosure[1]	REO[1]	Cumulative Realized Losses (as % of orig. bal.)[1]
Total	52.1	42.9	10.3	1.80	0.70	0.56	3.06	0.41	0.07	0.01
Seasoned[2]										
Total	30.7	22.3	11.4	2.13	0.93	0.77	3.83	0.59	0.13	0.01
Fixed Rate										
30 year[3]	7.8	6.7	8.6	1.38	0.85	0.43	2.66	0.30	0.07	0.01
15 year[4]	1.9	1.3	8.4	0.48	0.45	0.22	1.15	0.05	0.00	*
Adjustable Rate										
No negative am	15.0	10.3	12.5	2.59	1.05	1.10	4.74	0.70	0.15	0.02
Negative am	5.5	3.7	13.7	2.61	0.75	0.62	3.98	0.91	0.21	0.01
Graduated Payment	0.3	0.3	10.5	0.93	2.81	0.00	3.74	0.00	0.00	0.00

[1] Assumed to be 0 for pools not reporting data.

[2] Pools originated by 9/30/89.

[3] Includes pools with some 15- and 20-year mortgages.

[4] Includes bi-weekly mortgages.

*less than .005 percent

ties, credit enhancement typically ranged from 8 percent to 13 percent of the initial balance. These levels of credit enhancement were similar to the levels in 1989.

Trend toward concentration

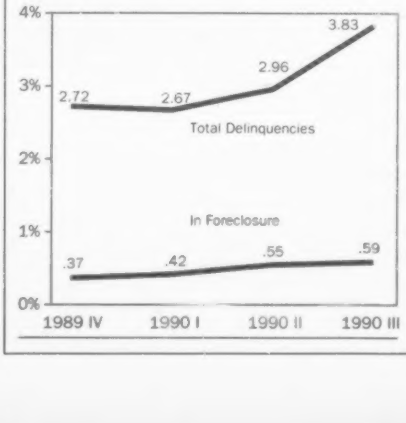
The consolidation in the financial industry has also affected the activity of issuers of mortgage pass-throughs. The top 10 issuers of pass-through securities in 1990 accounted for 76 percent of total volume, compared to 67 percent in 1989 and 62 percent in 1988. In 1990, the top 10 issuers (with the dollar amount of issuance in parentheses) were these:

1. Residential Funding Corporation ($3.9 billion)
2. Citicorp Mortgage Securities ($3.3 billion)
3. Prudential Home Mortgage ($3.0 billion)
4. Chase Mortgage Finance ($1.5 billion)
5. Cal Fed S&L ($1.4 billion)
6. Ryland Mortgage Securities ($1.4 billion)
7. Travelers Mortgage Services ($1.2 billion)
8. Citibank, N.A ($1.1 billion)
9. Guardian Savings ($0.9 billion)
10. Sears Mortgage Securities ($0.8 billion)

In 1989, the top five issuers (Citicorp Mortgage Securities, Residential Funding Corporation, Ryland Mortgage Securities, Travelers Mortgage Services, and Prudential Home Mortgage) were responsible for 47 percent of all issues. Last year, the share of the top five issuers increased to 54 percent of the total. Moody's expects the trend toward further consolidation to continue in 1991 and beyond.

CHART 1

Delinquency Rates on Seasoned Mortgage Pass-throughs



Delinquencies on the rise

As shown in Chart 1, mortgage delinquencies have been on the rise over the past year. At the end of the third quarter 1990, total delinquencies on seasoned pass-throughs rose to almost 4 percent of outstanding balances, compared with less than 3 percent at the end of 1989. Loans in foreclosure also rose to a new high of 0.59 percent, compared with 0.37 percent at the start of the year.

Seasoned pass-throughs, defined as those initially rated by Moody's more than a year ago, had a remaining balance of about $22 billion as of September 1990 (see Table 2). At that time, all pass-throughs rated by Moody's had a current balance of $43 billion, with a total delinquency rate of 3.06 percent. Seasoned pass-throughs tend to have higher delinquency rates because they are past the period of low delinquencies that are characteristic of the early months of a pool.

> *The best performing loans in outstanding mortgage pass-throughs are 15-year, fixed-rate mortgages, with a total delinquency rate of just in excess of 1 percent.*

A breakdown of the delinquency and foreclosure rates for different types of loans in mortgage pass-throughs as of September 1990 shows that ARMs in pools clearly demonstrated a higher delinquency rate than fixed-rate mortgages in pools. Adjustable-rate mortgages had the highest delinquency rate of loans packaged into private pass-throughs, with nearly 5 percent of the ARMs without negative amortization delinquent in September 1990. ARMs with the potential for negative amortization had a slightly lower delinquency rate, about 4 percent. Most of the negatively amortizing loans were originated in California, where the total delinquency rate is below the national average.

Fixed-rate mortgages pooled into seasoned private pass-throughs have a delinquency rate of less than 3 percent. The best performing loans in outstanding mortgage pass-throughs are 15-year, fixed-rate mortgages, with a total delinquency rate of just in excess of 1 percent. About 1 percent of ARM pools are in foreclosure or held as real estate owned, three times the rate for fixed-rate loans. A mere 5 basis points of 15-year, fixed-rate loans in pass-throughs are in foreclosure.

In regional markets, delinquencies on residential, first-mortgage loans originated in California are well below the national average, while delinquencies are rising in the New York-New Jersey-Connecticut area on residential, first-mortgage loans (see Table 3). At the end of the year, delinquency rates on California pools were just above 1 percent and had trended down from rates earlier in 1990. The weakness in California home prices had yet to manifest itself in higher delinquency rates in early 1991. In contrast, the percentage of nonperforming residential, first-mortgage loans in the New York area trended up through the year, ending near 3.5 percent. Loans in foreclosure in New York area pools rose to 81 basis points, more than double the percentage at the start of 1990.

All seasoned pools paid down at a rate of about 1 percent a month, or 13 percent at an annual rate in 1990. Paydown rates for ARMs averaged an annual rate of nearly 20 percent in 1990, although the rate slowed to below 15 percent toward the end of the year. The paydown rate for fixed-rate mortgages typically ranged between 6 percent and 8 percent at an annual rate.

The reason for the year-end slowdown in prepayments was partly seasonal and was partly attributed to fewer home sales in a weak economy. If continued economic weakness brings lower mortgage rates as expected, prepayment rates should rebound as refinancing activity increases. At a 20 percent paydown rate, a pool will be reduced to approximately half of its original balance in three years.

Collateralized mortgage obligations

Issuance of CMOs totaled slightly higher than $100 billion in 1990, up about 10 percent from the level in 1989. The increase in volume was attributed to a rise in mortgage originations, as well as increased demand by both foreign and domestic investors for CMOs with classes tailored to meet the specific needs of certain investors.

1990 was the second full year in which there were no volume limits on Fannie Mae/Freddie Mac direct issuance. As in 1989, direct issuance by Fannie Mae and Freddie Mac accounted for more than 85 percent of the total. The remainder was composed of issues using GNMA pass-throughs as collateral and issued privately. Privately issued CMOs typically receive an Aaa rating.

Moody's expects issuance of CMOs in 1991 to rise modestly to about $110 billion, with Fannie Mae and Freddie Mac again dominating the market. It is expected that GNMA will issue its first CMO/REMIC using its own collateral in the near future. However, the first GNMA CMO may not be issued until 1992.

The collapse of Drexel Burnham Lambert in early 1990 raised questions about the safety of privately issued CMOs. The main concern was that the failure of a party involved with a transaction could threaten the cashflows of the CMO. Moody's confirmation of its Aaa ratings on CMOs within Drexel's CMO program allayed fears about that particular program. However, because of overall weaknesses in the financial system, Moody's must continue to closely monitor the parties involved in a privately issued and rated CMO.

Outlook: more delinquencies, but adequate credit support

The sluggish economy in the first half of 1991 should produce further deterioration in home prices, especially in such markets as the Northeast, which are already in an economic slump. An acceleration of home price declines will lead to higher delinquency, foreclosure and loss rates on the mortgages underlying pass-through securities.

Almost all Aaa-rated and Aa-rated issues will have credit support equal to several multiples of collateral losses in a moderate recession. Although losses should rise as the economy weakens, the mortgage collateral underlying seasoned pass-throughs at year-end had suffered losses totaling only 1 basis point (.01 percent) of original balances. Currently, the level of credit enhancement for seasoned pass-throughs is more than 11 percent of outstanding balances.

Pass-through issuance in 1991 is expected to increase slightly over the 1990 level. The issuance of home equity, second mortgage-backed securities is expected to rise to about $10 billion in 1991 from $5.6 billion last year.

New and existing home sales are expected to continue at a slow pace. However, falling interest rates will increase the volume of refinancing. Institutions facing capital constraints will also be under pressure to sell assets. **MB**

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TABLE 3

Regional Delinquency Rates, March 1989-Nov. 1990

			Percentage of Non-Performing Loans (by Principal Amount)					Cumulative Realized Losses[1]	Annualized Paydown Rate
			30 Days	60+ Days	Total	In Foreclosure[1]	REO[1]		
CALIFORNIA	March	1989	1.38%	0.08%	1.46%	0.03%	0.00%	0.00%	10.5%
	June	1989	0.77%	0.03%	0.80%	0.03%	0.00%	0.00%	10.5%
	Sept.	1989	1.10%	0.44%	1.54%	0.00%	0.00%	0.00%	11.8%
	Dec.	1989	1.85%	0.34%	2.19%	0.04%	0.00%	0.00%	12.7%
	March	1990	2.06%	0.53%	2.61%	0.10%	0.00%	0.00%	13.0%
	April	1990	1.05%	0.35%	1.40%	0.19%	0.00%	0.00%	12.2%
	May	1990	2.03%	0.66%	2.69%	0.04%	0.00%	0.00%	9.2%
	June	1990	1.70%	0.41%	2.11%	0.00%	0.00%	0.00%	11.3%
	July	1990	0.90%	0.23%	1.14%	0.03%	0.00%	0.00%	11.6%
	August	1990	0.75%	0.43%	1.18%	0.03%	0.00%	0.00%	12.7%
	Sept.	1990	0.60%	0.23%	0.83%	0.11%	0.00%	0.00%	10.4%
	Oct.	1990	0.81%	0.16%	0.97%	0.12%	0.00%	0.00%	12.6%
	Nov.	1990	1.14%	0.19%	1.33%	0.12%	0.00%	0.00%	8.1%

			Percentage of Non-Performing Loans (by Principal Amount)					Cumulative Realized Losses[1]	Annualized Paydown Rate
			30 Days	60+ Days	Total	In Foreclosure[1]	REO[1]		
NY/NJ/CT	March	1989	1.17%	0.24%	1.41%	0.04%	0.00%	0.00%	9.1%
	June	1989	1.72%	0.43%	2.14%	0.07%	0.04%	0.00%	7.3%
	Sept.	1989	1.69%	0.67%	2.36%	0.19%	0.00%	0.00%	9.4%
	Dec.	1989	1.56%	0.95%	2.50%	0.35%	0.00%	0.00%	13.2%
	March	1990	1.38%	0.90%	2.27%	0.30%	0.00%	0.00%	12.5%
	April	1990	2.07%	1.12%	3.20%	0.36%	0.00%	0.00%	13.7%
	May	1990	1.73%	1.37%	3.11%	0.41%	0.00%	0.00%	10.0%
	June	1990	1.84%	1.45%	3.29%	0.45%	0.00%	0.00%	12.9%
	July	1990	2.18%	1.30%	3.48%	0.48%	0.00%	0.00%	15.8%
	August	1990	1.61%	1.54%	3.14%	0.52%	0.00%	0.00%	14.3%
	Sept.	1990	2.06%	1.49%	3.56%	0.52%	0.00%	0.00%	10.9%
	Oct.	1990	1.75%	1.77%	3.51%	0.63%	0.06%	0.00%	11.7%
	Nov.	1990	1.66%	1.65%	3.32%	0.81%	0.06%	0.00%	10.6%

[1] Assumed to be zero for pools not reporting data. Real estate owned (REO) represents the book value of property acquired through foreclosure or grant of a deed in lieu of foreclosure in respect to any mortgage loan.

JUMBO OPPORTUNITIES

High-balance loans can offer high-end profits.

1990 WAS A BANNER YEAR for the securitization of residential mortgage loans. A whopping 64 percent of last year's estimated mortgage originations were securitized.

The jumbo mortgage loan sector saw the biggest jump in securitization. During 1990, jumbo loan securities totaled $24.4 billion, or approximately 40 percent of the $61.5 billion in total jumbo loan originations. In the previous year, only 24 percent of the $59.3 billion in jumbo loan originations found their way into mortgage-backed securities.

The reasons for the increase in securitization activity are many. They include tougher capital regulations for banks and thrifts, enhanced technology associated with the tranching of whole-loan cash flows and greater investor acceptance of whole loan-backed REMIC securities. This article will discuss the impact that securitization has on profit margins and balance-sheet management. We will investigate various credit-enhancement techniques and assess their RAP (regulatory accounting principles) and GAAP (generally accepted accounting principles) implications. Finally, we will address in detail the hold-versus-sell decision as it relates to the most important market participant—the shareholder.

Jumbo loan outlook

As banks and thrifts position themselves for 1992 regulatory capital levels, one would expect a continued increase in jumbo loan securitizations. However, widening credit spreads brought about by investors' concerns about mortgage portfolio performance in a recessionary environment, along with a scarcity of credit-enhancement vendors, will raise the cost of jumbo loan securitization in 1991.

PHOTOGRAPH BY THE IMAGE BANK

Overall, Security Pacific National Bank expects a moderate increase in jumbo securitization levels for 1991. As credit concerns abate as the recession draws to a close, we expect a meaningful increase in jumbo loan securitization. Table 1 depicts Security Pacific's estimates of the size of the jumbo loan origination market and the corresponding level of jumbo loan securitizations for the years 1987 through 1990.

In many respects, we can measure the maturity of the residential mort-

Scott McAfee and Luke Hayden

gage market by its pricing efficiency. Asset securitization enhances the efficiency of a financial product as well-defined markets for the product are developed. As mortgage bankers know, residential conforming mortgages have become a commodity over the past decade. Profit margins have been continually squeezed as well-capitalized, nontraditional players continue to consolidate secondary marketing and servicing activities. Table 2 depicts the estimated size of conforming mortgage loan originations and the associated securitization level for the years 1987 through 1990.

It is no accident that we have experienced higher levels of asset securitization as the conforming mortgage loan product has taken on commodity-like characteristics. In a similar fashion, we can expect continued growth in securitization of jumbo loans to have a meaningful and adverse impact on the profit margins associated with jumbo loan originations. The trick, of course, is to get into the game before all the spread is gone.

Unlike conforming residential mortgage products, jumbo loans may offer reasonable rates of return when financed either on or off the balance sheet of a financial institution. Conforming loans, on the other hand, typically offer better rates of return when financed off the balance sheet, as the match-funded yield spreads associated with conforming loans are relatively thin. Financing off the balance sheet is nothing more than the sale of the mortgage asset with retention of the servicing fee.

Portfolio lending vs. jumbo securitization

Let's look at examples of portfolio lending (on-balance-sheet financing) and jumbo loan securitization. For purposes of this discussion, let us assume we have no hedging costs and we incur no gains or losses on the sale of jumbo loans. Additionally, let us assume we have a consistent annual production volume and a steady, 8 percent prepayment rate, starting with the second year of the life of the loan. We give some "ramp up" effect to our sales program beginning with $250 million in sales during the first year and leveling off with annual sales of $350 million in the second through the fifth year. Finally, let us assume we have no change in servicing costs over time. Given this utopian world, we can estimate returns on tier-one and risk-based capital levels.

As lenders bring their capital levels in line with 1992 requirements, we can expect a higher percentage of jumbo originations to be securitized.

The following assumptions compare the various income-statement, balance-sheet, and capital-ratio impacts associated with portfolio lending versus jumbo loan securitization. Our assumptions include an annual production volume of 400 million and an average loan size of $250,000, with an interest rate of 10.5 percent over 360 months. Prepayment speed is 8.0 percent, servicing costs are $75, and credit enhancement is .28 percent. The pass-through rate is 9.97 percent, and the match book funding costs are 9.0 percent. The tier-one capital level is 4 percent, and the tier-one hurdle level is 16 percent. Finally, risk-based capital is 2 percent, and the tax rate is 39.3 percent.

Table 1

(In billions)

Year	Jumbo Originations($)	Jumbo Securities($)	Percent of Securities
1990	61.5	24.431	40%
1989	59.325	14.238	24%
1988	57.534	15.850	27%
1987	67.431	11.100	16%

Table 2

(In billions)

Year	Conforming Originations($)	Conforming Securitizations
1990	282.8	61%
1989	273.3	52%
1988	269.5	35%
1987	285.1	49%

In a portfolio lending environment, our average assets reach $1.5 billion at the end of five years. These assets generate net interest income in the fifth year of $18.8 million. Because we have not sold any assets, we have not created a stream of servicing income. Consequently, our total income is $18.8 million. Taxes equal $7.4 million, and net profit after taxes equals $11.4 million. Return on average assets remains constant during years one through five at .7588 percent. Required tier-one capital reaches a high in year five at $60.2 million. Return on tier-one capital is approximately 19 percent. The corresponding return on risk-based capital is 37.9 percent.

Because we have not created an off-balance-sheet servicing asset, our return on assets, return on tier-one capital and return on risk-based capital remain constant from years one through five of our portfolio lending program. As we will see in our next example, the creation of an off-balance-sheet asset that produces a stream of income causes the return on assets, return on tier-one capital and return on risk-based capital to increase year over year. This is due to the reduction in average assets and the increase in service fee income as a result of the securitization activity.

If we embark upon a jumbo mortgage securitization program as described, average assets reach a high of $259.7 million in year five. The associated net interest income is $3.2 million. Net servicing income recognized in year five is $2.86 million. This has grown substantially from the annual net servicing income of $275,000 in year one. Total income for year five is $6.1 million. From this we must subtract $2.4 million for taxes. Net profit after tax in year five of our jumbo mortgage securitization program is $3.7 million. This represents a 1.42 percent return on average assets of $259.7 million.

By year five in our jumbo mortgage loan securitization program, average assets are less than 18 percent of the average assets that would have been generated in a portfolio lending environment. Similarly, required tier-one capital and risked-based capital levels are 82 percent lower than a portfolio lending program would dictate. Our $3.7 million net profit after tax represents a 35.7 percent return on tier-one capital required of $10.38 million. In a similar fashion, the $3.7 million net profit after tax represents a return on risk-based capital of 71.4 percent.

The creation of an off-balance-sheet servicing income stream has caused our return on assets (ROA) to trend up from .98 percent in year one to 1.42 percent in year five. Our return on tier-one capital has increased from 24.5 percent in year one to 35.7 percent in year five. Return on risk-based capital increased from 49 percent in year one to a robust 71.43 percent in year five.

While both portfolio lending and asset securitization would meet our tier-one equity hurdle rate of 16 percent, the creation of an off-balance-sheet service fee and an overall reduction in the size of the balance sheet associated with a securitization program will have a significant impact on our ROA, return on tier-one capital and return on risk-based capital. Of course, the world is not such a simple place. In real life, we would have the problems associated with varying production volume, overhead expenses, costs associated with asset and liability hedges and volatile prepayment speeds.

Jumbo loan lending affords opportunities both on and off the balance sheet. Off-balance-sheet opportunities are particularly attractive. But there are added benefits associated with a robust jumbo loan program, most notably in the area of cross-selling. The jumbo mortgage loan customer can be solicited for deposit products, such as checking accounts and money market instruments, as well as other loan products such as credit cards, home equity loans and car loans. Jumbo loan borrowers tend to make greater use of the financial services offered through banks and thrifts.

Credit-enhancement alternatives

The greatest difficulty associated with jumbo loan securitization is acquiring the appropriate credit enhancement to achieve the necessary ratings from the rating agencies. There are four specific risks that must be covered to achieve AA/Aa or AAA/Aaa ratings. These risks are:

Credit loss—the risk associated with the borrower not making his monthly mortgage payment.

Special hazard losses—the risk associated with the failure of standard hazard insurance policies carried by the homeowner to cover risks associated with various causes of physical damage. These special-hazard risks include earthquakes and vandalism.

There are added benefits associated with a robust jumbo loan program, most notably in the area of cross-selling.

Borrower bankruptcy—the risk associated with a bankruptcy court judge modifying a mortgage loan's interest rate or reducing its principal amount during bankruptcy proceedings.

Mortgage repurchase obligation—the risk associated with misrepresentation in the preparation of the loan application.

The second, third and fourth risk items above are often referred to as "splinter" coverages. These coverages typically total from 1.1 percent to 3 percent of a mortgage pool. Credit-loss coverage, on the other hand, typically represents 7 percent to 10 percent of a mortgage pool. Consequently, we will focus our attention on credit-loss coverage.

Credit-loss coverage

There are several ways to provide coverage for the risk of credit loss on a mortgage pool. They include:

- mortgage pool insurance
- subordination of a percent of the pool to the senior certificate holders
- letters of credit
- combinations of these techniques.

Pool insurance covers losses other than those due to borrower bankruptcy, special hazard and fraud. Pool insurance allows for regulatory and GAAP asset sale treatment for 100 percent of the pool. However, special hazard, fraud and bankruptcy losses must be covered by other forms of credit enhancement.

To be eligible for pool insurance, the mortgage loans must be underwritten in accordance with the guidelines established by the pool insurer. These guidelines are often more stringent than the underwriting policies of portfolio lenders and those lenders who enhance customer service levels through streamlined documentation. Because pool policies are provided by third-party vendors, investors in mortgage-backed securities that use credit enhancement through pool insurance are exposed to third-party event risks. That is, should the pool insurer be downgraded, so will the mortgage-backed security.

The most popular form of credit enhancement in recent years has been the senior/subordinate certificates. In this scenario, a portion of the pool is subordinated to the senior class. All losses on the pool are applied first to the holders of the subordinate certificates and, upon their retirement, to the holders of the senior certificates. Additionally, the senior/subordinate technology can be used to cover the splinter risks described above as well as the credit risk.

Because the rating agencies allow for some covariance of risk between credit losses and special hazard, fraud and bankruptcy losses, the total amount of subordination required to cover all losses is typically less than the amount of insurance coverage that would be required for each loss on an incremental basis. Investors prefer the senior certificates of senior/subordinate structures, because there is no third-party event risk that can result in the downgrading of the senior certificates. Consequently, the senior certificates tend to trade at tighter spreads to the Treasury yield curve than other types of credit-enhanced certificates.

The major problem with the senior/subordinate credit enhancement structure is the requirement that the subordinate certificate must be sold to achieve asset-sale treatment for regulatory purposes. Unfortunately, the market for subordinate certificates is highly illiquid.

A credit-enhancement structure borrowed from asset-backed securities involves using a letter of credit. In this structure, a highly rated financial insti-

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tution provides a letter of credit that can be drawn upon to cover losses associated with credit risk, special hazard loss, bankruptcy or fraud.

The letter-of-credit writer typically requires some form of reimbursement agreement or "spread account." Spread accounts are typically funded with an initial deposit by the issuer and an allocation of monthly excess servicing cash flows. The letter-of-credit writer recoups his losses from available amounts in the spread account. Typically, the spread account must grow to a level equal to the size of the letter of credit. At this point, the letter of credit is retired and no additional cash flows are required to be delivered to the spread account.

In effect, the letter-of-credit writer has created a lien on the excess servicing rights of the issuer. Consequently, the excess servicing cannot be capitalized for regulatory accounting purposes. As a result, the use of a spread account (or other type of reimbursement agreement) typically results in a dramatic mismatch between RAP proceeds and GAAP proceeds.

Once the spread account is fully funded, the excess servicing cash flows can be taken into income as earned. Unlike asset-backed structures, the amount of excess servicing spread associated with first-mortgage transactions is typically small (indicative of the transformation of first mortgage products into commodities). Consequently, the spread account funds over an extremely long period of time and, hence, greatly reduces the present value of the excess servicing rights one could reasonably expect to earn after the spread account is fully funded.

Creative techniques

Recently, creative issuers have borrowed from each of the above approaches to create mechanisms of credit support that satisfy their objectives.

For example, we have seen letters of credit or pool insurance used in combination with senior/subordinate certificates. In this environment, the benefit of the pool insurance might run only to the subordinate certificate holder, thereby causing the subordinate certificate holder to have a rating equal to the rating on the senior certificate. The senior certificate trades better because it looks only to the subordinate certificate for credit enhancement. Hence, it is not exposed to third-party event risk. Other transactions have been done with 50 percent of the credit enhancement provided in the form of subordinate certificates and 50 percent of the credit enhancement provided in the form of letters of credit.

Techniques in covering the risk associated with special hazard losses, bankruptcy and fraud are no less creative. In the early days of jumbo mortgage securitization, issuers typically purchased special hazard insurance policies from multi-line property and casualty insurers. These insurers routinely provided surety bonds for bankruptcy and fraud risks.

Today, these risks are covered through insurance policies, letters of credit backed by spread accounts or cash deposits into reserve funds. Recently, one of the nationally recognized rating agencies dramatically increased its requirements for borrower bankruptcy coverage. In a recent transaction, the change in the bankruptcy coverage requirement resulted in coverage levels five times greater than previously required.

Choosing a structure

Now that we have identified the opportunities in the jumbo loan market and the various types of structures we can use to securitize jumbo loans, how do we decide what structure to use? Like any other financial transaction, the answer lies in clearly defining your financial objectives.

The most basic question lies in determining whether you are trying to maximize your RAP capital formation or your GAAP capital formation. Capital formation is defined as the after-tax gain or loss on a sale plus the reduction in capital required to hold the mortgage loan assets on the books. GAAP gains/losses on sales are reduced by the issuer's estimated losses that will be incurred when supporting any of the four risks associated with the transaction: credit loss, special hazard loss, borrower bankruptcy loss and fraud loss.

Regulatory policy, however, does not allow an issuer to estimate probable losses and reserve for them accordingly. Rather, the issuer must write off the entire amount of exposure he has to any type of loss. Conse-

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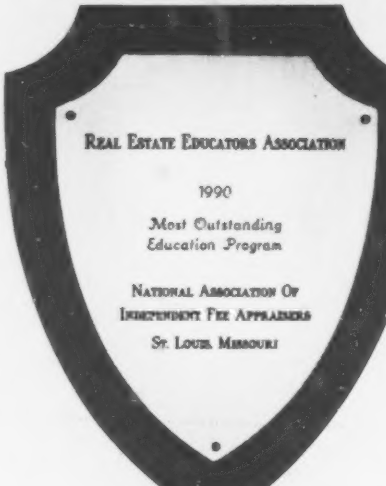
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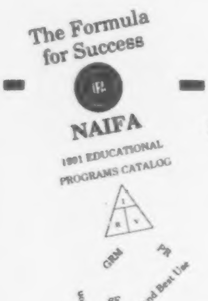

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quently, whenever spread accounts, reserve funds or other reimbursement agreements are used to support the various forms of risk, there typically exists a significant mismatch between RAP capital formation and GAAP capital formation.

RAP capital formation is typically maximized when the issuer purchases credit-enhancement policies from third-party vendors without entering into reimbursement agreements, spread accounts or reserve funds. GAAP capital tends to be maximized when the issuer retains some risk that he can estimate with high probability and reserve for accordingly.

To sell or not to sell

How can a financial institution decide whether it is better to finance its jumbo mortgage loan production on its balance sheet or whether to move it off the balance sheet and merely take the income associated with the servicing activities?

From the perspective of a shareholder, financial institutions should sell their mortgage loan production when the present value of the expected servicing income plus the gain/loss on sale exceeds the present value of the expected net interest income minus the cost of capital associated with carrying the asset on the balance sheet.

For an illustration, let us return to the utopian world we crafted for our discussion of various return ratios in portfolio lending and securitization environments. Let us assume the market for fixed-income instruments has rallied such that the sale of $250 million of fixed-rate jumbo mortgages will produce a pre-tax gain of $3.750 million. (Remember, this is Utopia.)

Let us examine the benefits to the shareholder before and after asset securitization. The present value of the net interest income earned over five years on $250 million of jumbo loans is approximately $9.171 million. At a tier-one capital level of 4 percent, the bank will be required to hold approximately $10.0 million in tier-one capital to support this asset. (The capital initially allocated will be reduced as the loans amortize and prepay.) Given a tier-one hurdle rate of 16 percent, the shareholder would be unwilling to use this capital unless we generate a present-value return of at least $6.446 million.

The difference between what the asset produces and what the shareholder requires is the excess benefit to the shareholder. In this case it totals $2.724 million.

Now assume for a moment that we securitize the $250 million of jumbo mortgages and recognize servicing fee income and a one-time gain on the sale. In this transaction, the bank would recognize a net stream of servicing-fee income equal to 22 basis points. The present value of this stream of income is $1.345 million.

Additionally, the one-time, after-tax gain on sale on the mortgages is $2.276 million. Because the assets have been sold, there is no capital support requirement and, hence, no required return on capital. We see the revenue from selling the asset equals the present value of the net servicing fee plus the gain on the sale, which totals $3.621 million. From this, we must subtract the after-tax transaction expenses of $.242 million. This asset securitization produces a net benefit to the shareholder of $3.378 million and deploys no capital. From this point of view, we clearly see that the sale of the asset provided a higher benefit to the shareholder.

Conclusion

The securitization of jumbo mortgage loans has not reached the level of efficiency demonstrated by conforming loan securitization. Consequently, the profit margins associated with jumbo loan originations remain wide enough to attract both portfolio lenders and mortgage bankers. Gaining a better understanding of credit-enhancement techniques and their impact on RAP and GAAP capital formation will allow lenders to maximize their return on capital.

As lenders bring their capital levels in line with 1992 requirements, we can expect a higher percentage of jumbo originations to be securitized. This will squeeze jumbo loan profit margins, which in turn, will reduce the desire of portfolio lenders to hold these loans on their balance sheet. As with all maturing markets, the consumer emerges the winner with lower incremental costs. **MB**

Scott McAfee is executive vice president and Luke Hayden is senior vice president of Security Pacific National Bank, Cypress, California.

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Mortgage Banking in May...

Residential Lending is the focus of May's *Mortgage Banking.* Articles include:

- RTC running mortgage companies
- MBS market in Canada
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- Insider fraud in mortgage companies
- Goldome's new MaxiMiser mortgage
- Managing risk in mortgage banking

ECONOMIC TRENDS

Demographic shifts in the U.S. have been well documented. The baby boomers—those individuals born between 1946 and 1964—have moved through the age distribution of the population like a "pig in a python." In 1991, the first cohort of baby boomers hit 45 years old, with the rest of the herd in their late 20s to early 40s. Chart 1 shows the number of households in which the head is 35 to 44 years old. The surge in the number of households in this age group during the 1980s reflects the influx of the baby boomers. Currently, there are around 20 million households headed by 35 to 44 year olds—more than one-fifth of all households in the United States. This age group traditionally has represented a sizable component of the move-up market—particularly those individuals with growing families and affluence who are seeking larger homes with more amenities.

CHART 1

Households Headed by 35–44 Year Olds

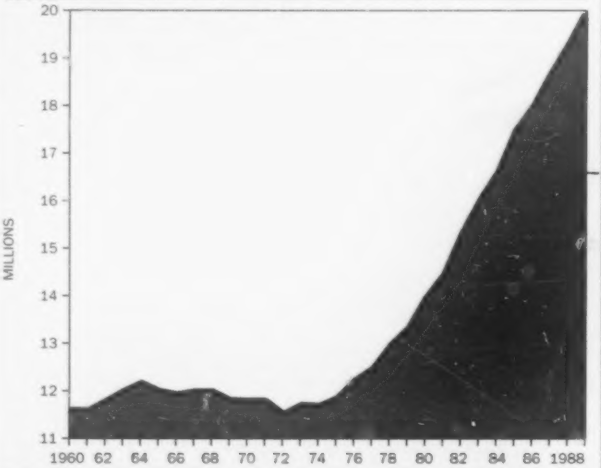


TABLE 1

Characteristics of New Homes Sold

Characteristic	Percentage of New Homes with the Characteristic					
	1980	1986	1987	1988	1989	1990
Central air conditioning	63	69	71	75	77	76
2½ bathrooms or more	25	33	38	42	44	45
4 bedrooms or more	20	20	23	26	28	29
1 fireplace or more	56	62	62	65	65	66
Garage for 2 cars or more	56	60	65	66	70	72
Addendum:						
Average size (square feet)	1,740	1,825	1,905	1,995	2,035	2,080

The maturation of the baby boomers has not gone unnoticed by home builders. To cater to the sheer size of the move-up market of baby boomers and to respond to the apparent national preference for bigger and better homes, builders have increasingly upped the size of homes they are building and the features in those homes.

Statistics on new homes vividly illustrate the trend. Table 1 shows selected characteristics of new homes completed in the past 10 years or so from 1980 to 1990. In 1980, the average size of new homes built was only 1,740 square feet. Of these new homes, 63 percent had central air conditioning, 25 percent had two and a half bathrooms or more, 20 percent had four bedrooms or more, 56 percent had one fireplace or more, and 56 percent had a garage for two cars or more. The average price was $76,400.

Times have changed. In 1990, the average size of new homes built was 2,080 square feet. Of these new homes, 76 percent had central air conditioning, 45 percent had two and a half bathrooms or more, 29 percent had four bedrooms or more, 66 percent had one fireplace or more, and 72 percent had a garage for two cars or more. The average price was $150,000— nearly double what it was 10 years earlier.

The annual patterns during the late 1980s clearly support the view that there is still momentum in the direction of larger homes with more amenities. One implication is that average prices are likely to continue to rise.

Size and amenities do not come free. Part of the increase in new home prices in the 1980s reflected fundamentals such as rising incomes, rising construction costs and the like, but changes in the nature of new homes—in their size and in their amenities—also had a lot to do with the general rise in prices of new homes. As noted, the average new home price increased 96.3 percent from 1980 to 1990, nearly doubling. The U.S. Census Bureau estimates that nearly half of this increase came as a result of increases in the size of units and the features of those units. Prices for new homes that were the same size and had the same amenities would have only increased 49.3 percent.

One implication of this trend toward larger and fancier homes is that new additions to the housing stock will continue to be inherently more expensive than units currently in the stock. Partly as a consequence, housing affordability is likely to remain an important national problem for years to come.

Thomas M. Holloway
Senior Economist

VITAL STATISTICS

Interest Rates & Yields

1- To 4-Family Mortgages

	FHA OPINION SURVEY	FHFB			FNMA		FHLMC	
		CONVENTIONAL[2]						
1990	FHA New Homes[1]	FRM	ARM	Median Cost of Funds SAIF Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
NOV	10.02%	10.39%	9.07%	9.69%	7.60%	9.87%	8.08%	9.90%
DEC	9.74	10.20	8.94	9.58	7.34	9.56	7.93	9.67
1991 JAN	9.62	10.04	9.03	9.54	7.10	9.51	7.74	9.64
FEB	**NA**	**NA**	**NA**	**NA**	**6.81**	**9.25**	**7.65**	**9.37**

Selected Securities

			U.S. GOVERNMENT				
1990	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
NOV	7.81%	7.91%	7.03%	7.31%	7.74%	8.39%	10.07%
DEC	7.31	7.80	6.70	7.05	7.47	8.08	9.95
1991 JAN	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB	**6.25**	**6.49**	**5.93**	**6.27**	**7.08**	**7.85**	**9.54**

Current Secondary Market Yields

Spreads

(Basis Points)

1990	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
NOV	9.63%	9.66%	9.54%	124%	127%	115%
DEC	9.22	9.27	9.16	114	119	108
1991 JAN	9.17	9.24	9.12	108	115	103
FEB	**8.81**	**8.86**	**8.77**	**96**	**101**	**92**

Secondary Market Activity

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1990	Commitments*	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
OCT	$1,849	$2,077	$287,674	$8,078	$7,260	$10,972	$6,118	$5,734	$5,748	$5,347
NOV	2,426	2,078	293,710	8,199	9,948	10,164	6,981	6,314	5,008	5,890
DEC	2,104	2,410	299,833	8,010	7,230	12,938	10,638	9,918	4,170	4,628
1991 **JAN**	**1,889**	**1,781**	**302,737**	**4,830**	**5,149**	**8,437**	**5,018**	**4,438**	**3,612**	**4,459**
1990 TOTAL	23,689	23,959	---	96,695	77,412	102,400	75,518	73,815	64,709	64,349
1989 TOTAL	27,409	22,518	—	69,764	85,408	86,263	78,589	73,518	62,000	57,262
1 MONTH AVG. 1991	1,889	1,781	—	4,830	5,149	8,437	5,018	4,438	3,612	4,459
1990	1,659	2,214	—	7,760	7,603	8,020	6,423	7,764	5,052	5,236
1989	1,087	1,037	—	4,074	3,492	5,206	3,586	3,408	4,972	4,291

*Does not include standby commitments issued, but includes standby commitments converted.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
OCT	1,026	861	165	920	751	169	144	230	392	260	113	200	354	253
NOV	1,130	823	307	906	713	193	147	232	483	268	105	195	367	239
DEC	975	766	209	844	688	156	109	233	400	233	100	178	337	229
1991 JAN	**850**	**661**	**189**	**804**	**646**	**158**	**77**	**198**	**340**	**235**	**99**	**187**	**301**	**217**
1990 TOTAL	1,193	932	261	1,104	852	252	131	253	480	329	124	235	425	321
1989 TOTAL	1,376	1,059	318	1,338	998	340	179	266	536	396	179	252	505	402
1 MONTH AVG. (SAAR)														
1991	850	661	189	804	646	158	77	198	340	235	99	187	301	217
1990	1,543	1,131	412	1,739	1,076	663	158	364	522	499	194	481	636	428
1989	1,659	1,254	405	1,455	1,095	360	288	304	639	428	231	284	551	389

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
OCT	3,070	2,640	10.3	465	334	8.7
NOV	3,150	2,580	9.8	486	327	8.1
DEC	3,130	2,100	7.9	465	319	8.4
1991 JAN	**2,910**	**2,310**	**9.5**	**408**	**316**	**9.3**
1990 TOTAL	3,308	—	—	535	—	—
1989 TOTAL	3,440	—	—	650	—	—
1 MONTH AVG. (SAAR)						
1991	2,910	—	—	408	—	—
1990	3,470	—	—	627	—	—
1989	3,660	—	—	704	—	—

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

1990	Total[5]	1−Unit	2+ Units	Nonresidential
OCT	$280.9	$93.3	$17.0	$89.1
NOV	272.1	90.6	16.0	86.7
DEC	267.6	87.8	16.6	86.9
1991 JAN	**264.5**	**82.3**	**16.1**	**86.9**
1990 TOTAL	294.1	100.7	17.4	92.7
1989 TOTAL	308.5	108.3	20.7	96.0
1 MONTH AVG. (SAAR)				
1991	264.5	82.3	16.1	86.9
1990	308.9	110.1	18.0	94.0
1989	321.1	114.8	21.3	98.4

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1990 MAY	$37,255	$9,420	$13,183	$14,231	$27	$2,453	$297	$1,061	$874	$39	$15,412	$110	$640	$10,905	$2,657
JUN	38,428	9,714	13,209	15,063	29	2,778	209	989	682	182	16,411	105	666	12,303	3,097
JUL	35,519	9,627	12,015	13,461	30	2,082	165	871	696	209	16,221	98	475	12,525	2,984
AUG	**36,651**	**11,236**	**12,937**	**12,032**	**34**	**2,556**	**80**	**950**	**1,243**	**92**	**18,964**	**107**	**647**	**14,783**	**2,994**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85,307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
8 MONTH AVG. 1990	35,707	9,489	12,200	13,588	56	2,680	375	948	891	195	17,106	122	666	12,935	3,027
1989	28,320	5,469	12,828	9,610	83	2,385	281	1,150	549	185	11,709	129	1,339	8,299	1,819
1988	32,044	7,307	15,459	8,702	232	2,995	367	1,634	554	280	15,250	73	2,053	10,922	1,994

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1990 SEP	119	68	14	37	109	$8,827	64	$4,319	14	$1,180	31	$3,328
OCT	133	74	20	39	120	9,756	66	4,476	19	1,612	35	3,668
NOV	113	62	15	36	107	8,554	63	4,225	14	1,207	30	3,122
DEC	**91**	**49**	**11**	**31**	**93**	**7,485**	**55**	**3,686**	**11**	**931**	**27**	**2,868**
1990 TOTAL	1,623	956	195	472	1,340	106,602	780	51,863	193	15,783	367	38,956
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
12 MONTH AVG. 1990	135	80	16	39	112	8,883	65	4,322	16	1,315	31	3,246
1989	141	83	16	42	106	7,996	61	3,824	15	1,079	30	3,093
1988	147	79	18	50	111	8,167	58	3,548	18	1,314	35	3,305

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

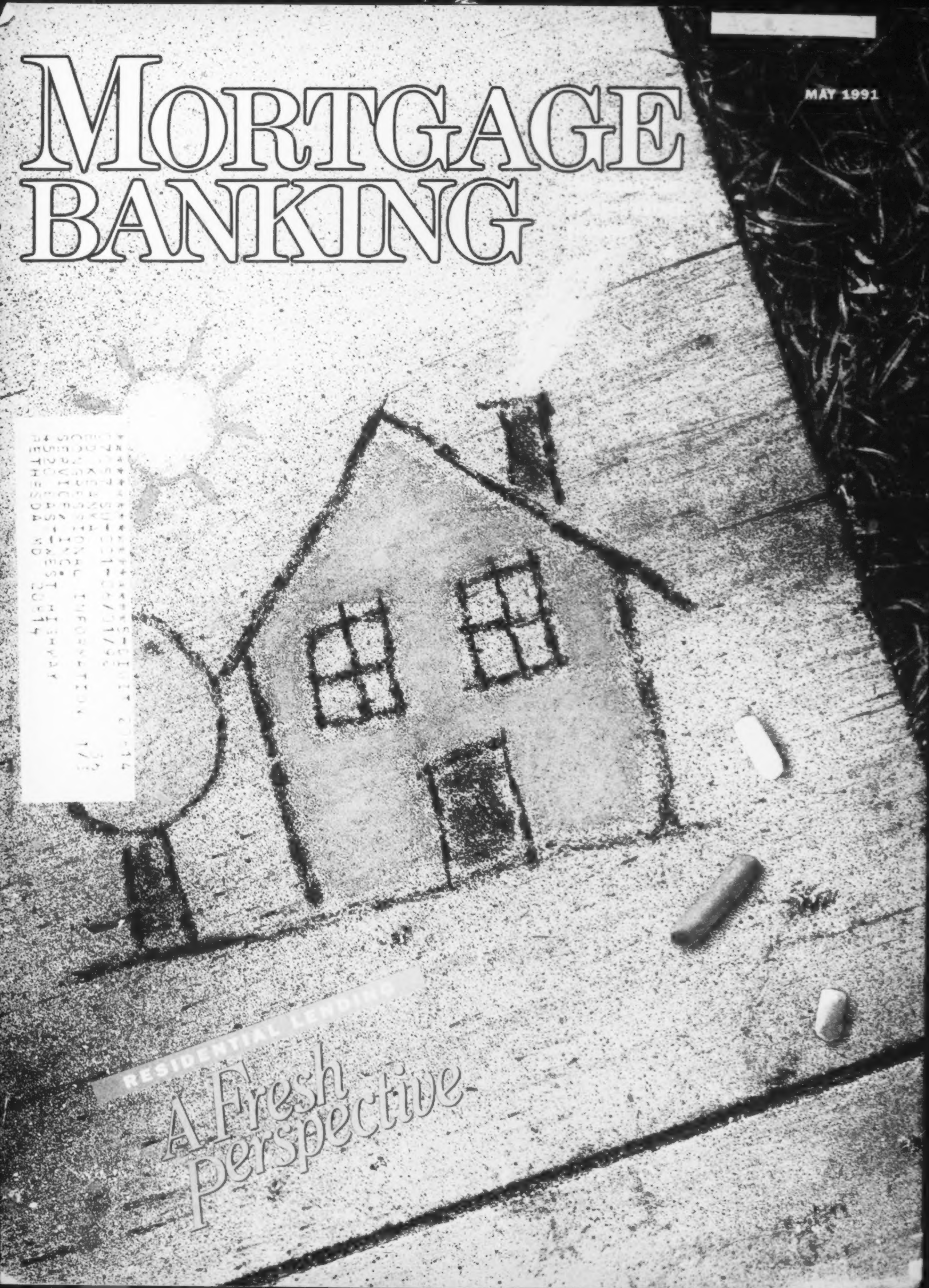
[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

MAY 1991

MORTGAGE BANKING



RESIDENTIAL LENDING

A Fresh perspective

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COVER:

Residential Lending

Some new approaches are sprouting up in the field of residential lending. In some instances, lenders are being very creative in the design of new mortgage products. In other areas, mortgage lenders are being resourceful in finding new sources of money to run their companies. Then, on top of that, there are newcomers to the block, like the RTC, who have changed the whole feel of the business. But the mission remains straightforward and simple—putting people in houses.

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PORTFOLIO

Chalking Up Some Gains

Mortgage bankers have reason to be cheered by the recent strong upturn in the origination market. The news is good on several fronts. Adjustable-rate mortgages have not represented any stiff competition for fixed-rate lenders in a long time.

The Mortgage Bankers Association of America's (MBA) economics department put the ARM market share at about 25 percent earlier this year. By early April, the ARM to fixed-rate mortgage spreads had widened to more than 200 basis points, yet fixed-rate mortgages remained at very attractive levels for consumers. The ARM is not expected to stage a big comeback in the near term.

That is all very rosy news for mortgage bankers. On top of that, the sheer number of thrifts pushing discounted ARMs has dramatically shrunk, which has stifled the fierce price-based competition of past years. Many of the purveyors of that strategy have now been put out to pasture courtesy of the RTC.

But there are many other hopeful signs that spring is here for mortgage bankers and that spring 1991 will be a good one. Solid mortgage banking operations have shown great resiliency in finding warehouse lines in the face of very tight credit conditions. New sources of equity [illegible] are being brought into the industry to buy up the abundance of servicing that has been coming onto the market. New and inventive mortgage products are being designed around ways to help beat the affordability problem and stretch the buying power of new homebuyers.

There are some potential weeds in the garden to spoil some of this good cheer. Refinancings are threatening to shrink some servicing portfolios, and mortgage bankers' market share has not bounded up to the peaks of recent years when fixed rates were at similarly desirable levels. MBA's economics department puts the residential market share of mortgage bankers for last year at only an average of 26 percent. Thrifts have drifted out of the picture increasingly, but banks have come on strong with close to a 40 percent share of home mortgage originations. Perhaps the results for 1991 will show a different story.

Janet Reilley Hewitt
Editor in Chief

COMING IN JUNE

Next month we will spotlight some of the key players and the strategies being followed in the buying and selling of servicing.

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THE DOWNGRADE ENVIRONMENT

Howard Esaki

The pace of rating downgrades picked up significantly during this year's first quarter. Private MBS issuers are plotting ways to preserve top ratings in the face of their credit enhancers' troubles.

Drexel Burnham Lambert failed in 1989. A record number of thrifts and banks failed in 1990. Major U.S. and foreign banks have had their credit ratings downgraded in the past year. How will these stresses to the financial system affect the credit quality of private mortgage-backed securities (MBS)?

Moody's Investors Service believes that although the strains on the financial system may have an adverse impact on selected mortgage pass-throughs, most highly rated private MBS are adequately protected against credit downgrades of affiliated financial institutions.

Private MBS: third-party risk

Private, residential, whole-loan pass-throughs are complex securities that frequently depend on a variety of external sources of credit support to obtain a high rating from Moody's. External or "third-party" credit support differs fundamentally from internal credit support, because the credit quality of the support may change as the rating of the entity providing support changes. Internal credit support, either in the form of cash or subordinated collateral, has the same value throughout the life of the security.

External support is primarily provided through pool insurance policies, letters of credit, corporate guarantees or surety bonds, all of which are used to protect against credit losses. In addition, external support is often used to cover risks from fraud, special hazard or borrower bankruptcy. A third party is also often involved in a mortgage pass-through transaction as an advancer and/or servicer, or in the role of a trustee.

No "weak-link" approach

When rating a private MBS, Moody's takes into account all the ratings of involved parties, as well as the total amount of credit support available. Moody's goal is that two securities with the same rating have the same expected change in internal rate of return as a result of credit losses. (For more details of this approach, see "Credit Analysis of Structured Securities," Moody's Investors Service, 1991.)

The credit performance of a private MBS depends not only on the performance of the underlying mortgages but also on the conditions and extent to which third parties fulfill their obligations. In determining a rating, Moody's analyzes a wide range of possible economic and legal conditions that would define the amount of cash flow into the structure and assigns a probability to each scenario. The average of these probability-weighted cash flows are then examined to compute an expected loss, and the number derived is compared with expectations for other structured and corporate bond ratings.

Moody's does not use a weak-link approach in rating private mortgage-backed securities. In other words, the rating of a security is not necessarily the lowest rating of the entities supplying credit support. Instead, Moody's looks at both the combined value of all the forms of support and the value of the unsupported collateral. The intrinsic value of the collateral supplements the credit quality of third-party support.

A default of a third party providing some form of credit support does not necessarily mean that a mortgage-backed security will suffer a cash shortfall. Moreover, even if it does, the severity of loss may be small, because investors receive funds from the unsupported collateral. Thus, depending on the quality of the assets and on the correlation of that quality with the fortunes of the third party, the credit quality of a transaction is usually higher than the credit quality of the third party itself.

MOODY'S GOAL IS THAT TWO SECURITIES WITH THE SAME RATING HAVE THE SAME EXPECTED CHANGE IN INTERNAL RATE OF RETURN AS A RESULT OF CREDIT LOSSES.

Example: Citicorp (Baa2); Citicorp pass-throughs (A2)

A prime example of the analysis discussed in the previous section is Moody's rating action, which affected Citicorp mortgage pass-throughs, in response to the downgrade of Citicorp's senior debt rating to Baa2 from A3 on January 25, 1991. On the same day, Moody's downgraded 48 mortgage-backed securities (totaling $3 billion) issued before March 1990, whose sole form of credit support was a Citicorp corporate guarantee. The guarantee amount typically ranged from 6 percent to 10 percent of the original balance.

Although Citicorp's rating was dropped 2 rating notches, the rating for most of the pass-throughs was lowered only one notch, to A2 from A1. The rating of the mortgage pass-throughs was three rating notches above the rating of the entity supplying credit support. (Four pass-through ratings were lowered to A3.)

In analyzing the rating of the pass-throughs, Moody's examined the cash flows to the security under both Citicorp default and no-default scenarios and assigned probabilities to each. The correlation between the mortgages underlying the pass-through and the performance of Citicorp was also examined. The conclusion was that the underlying strength of the unsupported mortgage collateral raised the rating well above the rating of the third-party guarantee.

Example: FBS pass-throughs maintain Aaa ratings

On August 13, 1990, Moody's downgraded the long-term rating of Dai-Ichi Kangyo Bank (DKB) of Tokyo from Aaa to Aa1 because of profitability and asset quality concerns. DKB provided a letter of credit (LOC) as support for two transactions issued in 1986 by FBS Mortgage Corporation, St. Paul, Minnesota.

The FBS pass-throughs consisted of 15-year mortgage collateral, with total delinquencies of less than 1 percent and no losses. More than one-third of each pool had paid off in the four years following the date of issuance, with no reduction of the initial level of credit support. Based on the strength of the mortgages in the pools, along with the Aa1 rating of the letter-of-credit provider, Moody's confirmed the ratings of the two FBS pass-throughs at Aaa.

Strengthening programs

One characteristic of the private MBS market that differs from the traditional corporate bond markets is that an issuer of an MBS will often attempt to strengthen a security or a program in order to maintain a certain rating or to attain a better rating for future transactions. This action is usually taken in response to a downgrade of a third party, which threatens the original rating of an existing pass-through.

As an example of protecting a program, in April 1990, Citicorp Mortgage Securities began to issue mortgage securities with credit support in the form of a combination of a subordinated class, a buildup of a spread account from excess interest and a 1 percent guarantee from Citicorp, which was in a first-loss position. In some later structures, cash was substituted for the 1 percent guarantee. This structure was formulated in response to both a changing regulatory environment and a downgrade of Citicorp in early 1990. Moody's determined that the new structure was consistent with the Aa3 and Aaa ratings sought by Citicorp Mortgage Securities.

Indeed, after the second downgrade of Citicorp a year later, the ratings of all pass-throughs using the new structure (20 transactions) were confirmed at the original rating levels. Citicorp had successfully transformed its program into one that was less vulnerable to third-party downgrade risk.

Another example of the ability of issuers to compensate for the downgrade of a third-party credit support provider was the response by several issuers of pass-throughs and collateralized mortgage obligations (CMOs) following the downgrade of Cypress, California-based Security Pacific National Bank in December 1990. Security Pacific provided backup advancing, that is, it advanced payments on delinquent loans if the primary advancer defaulted, in several transactions with a low-rated or unrated servicer. In some cases, a provision was added that stated if the short-term rating of Security Pacific was lowered below Prime-1 (Moody's highest short-term rating), the issuer would within 30 days place an amount of cash in an account to be used for advancing. The amount of cash was determined by examining the delinquency history of the transaction.

Five transactions issued by Western Federal Savings and Loan, Marina Del Ray, California, in 1990 also maintained Aa2 ratings following the Security Pacific downgrade by adding a provision stating that GEMICO, a Aaa-rated entity, would provide backup advancing. The Western Federal pass-throughs used GEMICO pool policies as credit support.

One option available to an issuer to maintain a rating is to replace a credit-support provider that has been downgraded with a higher-rated entity. This occurred last year when Residential Funding Corporation (RFC) of Minneapolis, Minnesota, responded to a downgrade of Tokyo-based Fuji Bank, Ltd., from Aaa to Aa1, which provided a letter of credit on a transaction issued earlier in the year. RFC substituted a letter of credit from the Aaa-rated Industrial Bank of Japan, Ltd., of Tokyo in order to maintain the Aaa rating on its pass-through.

Finally, two pass-throughs issued by Glendale Federal Bank, Glendale, California, in 1990 are examples of transactions initially structured to avoid third-party downgrade risk. The Glendale Federal securities use a Security Pacific National Bank letter of credit as credit support. In order to protect against the "event risk" of a Security Pacific downgrade, a provision was added to the original documents stating that if Security Pacific were to be downgraded below Aa3, the letter of credit would be drawn upon and placed in an eligible investment account. When Security Pacific was, in fact, downgraded in December, the LOC was drawn down, and the pass-throughs remained rated at Aa2 without any changes made to the transaction.

Private MBS credit ratings: how volatile?

While it is true that many pass-through transactions are protected from certain kinds of third-party risk, private-label mortgage-backed securities are by no means "downgrade proof." In 1990, Moody's downgraded the ratings on 56 mortgage pass-throughs, which represented about 10 percent of outstanding private mortgage pass-through ratings. As of the end of March, 48 pass-through ratings had been downgraded in 1991. Two questions arise. First, how does this compare with changes in Moody's more traditional ratings of corporate bonds? Second, are private MBS ratings more, or less, volatile than other ratings?

TABLE 1

Yearly Long-Term Rating Changes By Refined Rating Category, 1983 - 1990

(As a Percent of Amount in Category at Beginning of Year)

	Downgrades	Upgrades
Aaa	7.9	N/A
Aa1	10.1	2.3
Aa2	16.1	5.0
Aa3	14.1	4.1
A1	11.9	6.5
A2	13.0	7.6
A3	15.1	12.1
Baa1	16.1	12.4
Baa2	15.8	15.0
Baa3	17.6	14.0

N/A = not applicable

Source: Moody's Investors Service, February, 1991

The answers can be found in the results of a new study completed by Moody's Investors Service in February 1991, titled "Changes in Corporate Credit Quality 1970-1990." The study examines historical changes in the credit ratings of more than 4,000 rated U.S. and international debt issuers (industrial and utility companies, financial institutions, sovereign issuers and structured finance issuers) from 1970 through 1990. The study also analyzed trends in the direction and stability of the credit quality of rated issuers in the past 21 years.

One of the findings was that on average during the 1980s, approximately 12 percent of rated issuers ended the calendar year in a different long-term letter-rating category than at the beginning of the year. In 1990, the number of issuers with a rating change was also 12 percent. Table 1 summarizes the rating changes, by refined rating category, from 1983 through 1990.

For the double-A and triple-A rating categories, the ratings for most mortgage pass-throughs, an average of between 8 percent and 16 percent of ratings, were downgraded each year. A much smaller number, between 2 percent and 5 percent, were upgraded on average each year. The downgrade number for private mortgage pass-throughs in the past year, about 10 percent, is generally in line with the figures for all Moody's ratings.

The number of upgrades in the pass-through sector has thus far been below the average found for all Moody's ratings for 1990. One private MBS was upgraded in 1990, and four transactions were upgraded in 1989. Although the number of upgrades of private mortgage securities has been below the average for all Moody's ratings, the private MBS market is relatively new, with large volumes of transactions brought to market only in the last five years. A more statistically significant comparison of upgrades and downgrades of private mortgage-backed securities with other Moody's ratings can be made in the future as the number of transactions grows and as a longer rating history becomes known.

Most MBS well protected

Moody's continually monitors the private mortgage-backed securities it has rated for possible upgrades or downgrades. With a few exceptions, credit support for private mortgage securities is a large multiple of expected losses on the underlying mortgage collateral. In aggregate, as of year-end 1990, pass-throughs rated by Moody's had lost about 1 basis point (.01 percent) of original balances. The aggregate remaining credit support for these pools was more than 10 percent of the remaining balances.

> **WHILE IT IS TRUE THAT MANY PASS-THROUGH TRANSACTIONS ARE PROTECTED FROM CERTAIN KINDS OF THIRD-PARTY RISK, PRIVATE- LABEL MORTGAGE-BACKED SECURITIES ARE BY NO MEANS "DOWNGRADE PROOF."**

Since most pass-throughs appear adequately protected against a deterioration in mortgage quality, the major remaining concern is over a decline in the credit quality of the institutions providing various forms of credit support. Currently, very few pass-throughs appear to be threatened by the turmoil in the financial services industry. In many cases, the response of issuers to downgrades of institutions providing credit support has been either to replace the downgraded institution or to strengthen the structure of the transaction to maintain credit quality. In addition, the fundamental credit quality of the underlying residential mortgage collateral has acted as a cushion to protect private mortgage-backed securities from the shock waves emanating from the financial markets. **MB**

Howard Esaki, Ph.D., is a senior analyst and assistant vice president in the Structured Finance Group of Moody's Investors Service, New York.

VITAL STATISTICS

KEY ECONOMIC INDICATORS AND INTEREST RATES

	CHANGES IN PAYROLL EMPLOYMENT (THOUSANDS)	UNEMPLOYMENT RATE (%)	CHANGES IN CONSUMER PRICES FROM YEAR AGO LEVELS (%)		MORTGAGE INTEREST RATES (%)		
			ALL ITEMS	ALL ITEMS LESS FOOD AND ENERGY	SECONDARY MARKET YIELD ON FHA NEW HOME MORTGAGES[1]	FHLMC ARMs	FHLMC FRMs
MAR-90	164	5.3	5.2	4.9	10.26	8.53	10.27
APR-90	55	5.4	4.7	4.8	10.53	8.55	10.37
MAY-90	440	5.3	4.4	4.8	10.49	8.59	10.48
JUN-90	212	5.3	4.7	4.9	10.21	8.49	10.16
JUL-90	−89	5.5	4.8	5.0	10.15	8.43	10.04
AUG-90	−127	5.6	5.6	5.5	10.20	8.35	10.10
SEP-90	−1	5.7	6.2	5.5	10.26	8.28	10.18
OCT-90	−180	5.7	6.3	5.3	10.24	8.21	10.18
NOV-90	−267	5.9	6.3	5.3	10.02	8.10	10.01
DEC-90	−161	6.1	6.1	5.2	9.74	7.93	9.67
JAN-91	−233	6.2	5.7	5.6	9.62	7.74	9.64
FEB-91	−184	6.5	5.3	5.6	9.58	7.65	9.37
MAR-91	NA	NA	NA	NA	NA	7.47	9.50

RATES ON SELECTED SECURITIES (%)

	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT				A-Rated Utility
			6-Month	1-Year	3-Year	10-Year	
MAR-90	8.28	8.28	7.85	8.35	8.63	8.59	9.92
APR-90	8.26	8.30	7.84	8.40	8.78	8.79	10.09
MAY-90	8.18	8.25	7.76	8.32	8.69	8.76	10.04
JUN-90	8.29	8.14	7.63	8.10	8.40	8.48	9.85
JUL-90	8.15	7.99	7.52	7.94	8.26	8.47	9.96
AUG-90	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP-90	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT-90	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV-90	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC-90	7.31	7.80	6.70	7.05	7.47	8.08	9.95
JAN-91	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB-91	6.25	6.49	5.93	6.27	7.08	7.85	9.54
MAR-91	6.12	6.41	5.92	6.40	7.35	8.11	9.58

CURRENT SECONDARY MARKET YIELDS (%)

SPREADS

(Basis Points)

	GNMA[2]	FNMA[2]	FHLMC[2]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
MAR-90	9.87	9.85	9.84	128	126	125
APR-90	10.01	9.94	9.94	122	115	115
MAY-90	9.99	9.93	9.92	123	117	116
JUN-90	9.73	9.73	9.72	125	125	124
JUL-90	9.66	9.66	9.66	119	119	119
AUG-90	9.80	9.75	9.75	105	100	100
SEP-90	9.86	9.79	9.73	97	90	84
OCT-90	9.84	9.80	9.69	112	108	97
NOV-90	9.63	9.66	9.54	124	127	115
DEC-90	9.22	9.27	9.16	114	119	108
JAN-91	9.17	9.24	9.12	108	115	103
FEB-91	8.81	8.86	8.77	96	101	92
MAR-91	9.00	9.03	8.93	89	92	82

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED

By Type of Institution and By Type of Unit

(Millions of Dollars)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies
MAR-90	35,273	8,703	12,700	13,460	29	2,970	557	1,113	1,014	61	19,167	102	804	15,172	2,978
APR-90	35,407	7,543	12,400	15,122	28	1,973	145	935	698	50	18,984	100	621	14,796	3,048
MAY-90	37,255	9,420	13,183	14,231	27	2,453	297	1,061	874	39	15,412	110	640	10,905	2,657
JUN-90	38,428	9,714	13.209	15,063	29	2,778	209	989	682	182	16,411	105	666	12,303	3,097
JUL-90	35,524	9,627	12,020	13,461	30	2,082	165	871	696	209	16,222	98	476	12,525	2,984
AUG-90	36,654	11,236	12,940	12,032	34	2,556	80	950	1,243	92	18,967	107	650	14,783	2,994
SEP-90	30,117	5,732	10,617	13,347	36	1,961	131	855	608	112	20,231	102	577	16,100	3,343
OCT-90	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

BY TYPE OF UNIT

	HOUSING STARTS			BUILDING PERMITS		
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units
MAR-90	1,298	1,023	275	1,232	969	263
APR-90	1,217	952	265	1,108	870	238
MAY-90	1,208	935	273	1,065	853	212
JUN-90	1,187	931	256	1,108	844	264
JUL-90	1,155	907	248	1,082	838	244
AUG-90	1,131	865	266	1,050	818	232
SEP-90	1,106	893	213	992	786	206
OCT-90	1,026	861	165	920	751	169
NOV-90	1,130	823	307	906	713	193
DEC-90	971	768	203	844	688	156
JAN-91	850	680	170	797	647	150
FEB-91	989	820	169	865	736	129
MAR-91	NA	NA	NA	NA	NA	NA

BY REGION

	HOUSING STARTS				BUILDING PERMITS			
	Northeast	Midwest	South	West	Northeast	Midwest	South	West
MAR-90	138	276	520	364	145	249	453	385
APR-90	124	283	467	343	120	238	423	327
MAY-90	128	255	486	339	124	218	410	313
JUN-90	114	241	532	300	121	224	428	335
JUL-90	115	226	492	322	111	227	428	316
AUG-90	122	240	434	335	112	225	402	311
SEP-90	104	239	445	318	104	221	386	281
OCT-90	144	230	392	260	113	200	354	253
NOV-90	147	232	483	268	105	195	367	239
DEC-90	110	233	395	233	100	178	337	229
JAN-91	87	167	356	240	96	182	309	210
FEB-91	92	296	384	217	96	201	346	222
MAR-91	NA	NA	NA	NA	NA	NA	NA	NA

HOME SALES

(Units and Prices in Thousands)

	EXISTING HOMES		NEW HOMES		
	Sold (SAAR)	Median Sales Price (Dollars)	Sold (SAAR)	Median Sales Price (Dollars)	Months Supply At Current Sales Rate
MAR-90	3,440	96.3	559	119.4	7.7
APR-90	3,370	95.7	534	130.0	8.3
MAY-90	3,350	95.2	535	125.0	8.2
JUN-90	3,370	98.9	549	125.0	7.9
JUL-90	3,320	98.1	541	118.7	8.0
AUG-90	3,410	97.2	525	118.4	8.1
SEP-90	3,160	94.4	504	113.0	8.4
OCT-90	3,070	92.9	465	120.0	8.7
NOV-90	3,150	92.0	480	118.9	8.2
DEC-90	3,130	91.7	460	127.0	8.5
JAN-91	2,900	95.6	402	120.0	9.4
FEB-91	3,130	94.8	467	127.5	8.5
MAR-91	NA	NA	NA	NA	NA

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars,
Seasonally Adjusted Annual Rates)

	Total[5]	1-Unit	2+ Units	Nonresidential
MAR-90	316.3	114.3	18.2	95.6
APR-90	308.9	109.3	18.6	94.6
MAY-90	303.9	105.7	19.1	93.5
JUN-90	299.1	101.8	17.0	95.4
JUL-90	298.5	99.9	16.9	98.4
AUG-90	290.5	97.6	16.9	93.2
SEP-90	286.1	95.1	16.7	91.9
OCT-90	279.5	93.5	17.0	89.2
NOV-90	272.4	90.6	16.0	86.8
DEC-90	267.0	87.7	16.6	86.7
JAN-91	264.1	82.6	15.7	86.5
FEB-91	257.7	80.0	14.8	85.9
MAR-91	NA	NA	NA	NA

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Securities for 0- to 30-day delivery

[3] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[4] Savings & Loans and Mutual Savings Banks.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

JUNE 1991

MORTGAGE BANKING

THE [illegible]
OF REAL ESTATE
FINANCE

THE SERVICING MARKETPLACE

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COVER PHOTOGRAPH BY PAUL TRUMMER / THE IMAGE BANK

PORTFOLIO

Dizzying Dollars

Many, many packages have changed hands since the secondary market for servicing was created. The dollar figures are dizzying.

During the past 10 years, one of our authors speculates that perhaps as much as $1 trillion has changed hands. This is big business.

And the government is now the largest player in this grandiose enterprise.

How do you get the most for your wares using this complicated new currency that funds many a mortgage banker's operation? We asked some experts, and they say the way you slice up what you have to sell is very important. Getting just the right cross section will help fetch top dollar.

But sellers, it appears, need not worry about a shortage of buyers. A survey of 60 companies in this month's issue reveals that many servicers have aggressive plans to buy this year. Two-thirds of the surveyed companies replied to questions about their acquisition targets this year, and together they reported plans to add between 764,000 and 981,000 loans to their portfolios. At the root of these servicing expansion plans appears to be excess capacity. Excess capacity was a dirty word not so long ago, when it was used to describe what was wrong with the production side of the business. But when it comes to servicing, excess capacity means you have made the necessary investments to substantially grow your servicing business, which is good, the experts say. Because when you become a big servicer, those vaunted economies of scale come into play and reduce your per-unit servicing costs, unless you get too big, of course, and then you may be back to square one.

ARM servicing has its own unique problems. Because it is tough to do and, typically, more costly, buyer demand is limited. On top of that, payment-adjustment errors have been kicking up lawsuits and the wrath of regulators, which is something many would understandably rather avoid.

Janet Reilley Hewitt
Editor in Chief

COMING IN JULY

In July, we scope out what is driving the regulators to crack down so severely on commercial real estate loans. Next month our entire issue is devoted to a wide range of topics in commercial real estate finance.

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ARM SERVICING

An Exotic Species

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ARM servicing behaves in ways that make it less attractive to many servicers. Higher prepayments and more frequent foreclosures are typical for these portfolios, and that has depressed prices and sidelined some potential buyers.

Stephen Z. Hoff

If you ask most purchasers of mortgage servicing how they value ARMs, the answer you will probably hear is: "We don't." Many buyers in the market for servicing have little or no interest in ARMs. For example, one of the top five mortgage bankers reports that out of a portfolio of 575,000 loans, only about 1 percent are ARMs. A user-generated database compiled by McDash Analytics of about 4 million loans, consisting of the residential loan portfolios of 25 mortgage lenders, contains only 7.25 percent of ARM loans.

The McDash database is made up of regional and national lenders; approximately half hold servicing portfolios of 100,000 loans or more, and half hold 100,000 loans or less. Approximately 40 percent of the lenders in the database are mortgage bankers; 35 percent are thrifts; and 25 percent are banks.

The market's reluctance to buy ARM servicing is based on a number of factors including the perception of high payoffs, higher servicing costs resulting from periodic rate adjustments and the potential litigation expense associated with miscalculation of the rate adjustment. The Government Accounting Office published a study last year in which it estimated that as many as 25 percent of all ARM adjustments are calculated incorrectly.

Although adjustments began to appear in home loans as early as the late 1970s in California as variable-rate mortgages (VRMs) gained acceptance, mortgage loans with adjustable-rate features (ARMs) only emerged as an important market force in the U.S. single-family real estate market in the early 1980s. During that period of extremely high interest rates and an unusually high degree of rate volatility, ARM products offered a more attractive means of financing a home purchase. In addition, ARMs typically offered a discounted initial interest rate, which enabled more borrowers to qualify for the size loan they sought.

As ARMs became more popular in the early 1980s and thrifts became the dominant originators of ARMs, the Federal Home Loan Bank Board (FHLBB) touted ARMs as the preferred means of managing interest-rate risk. In theory, ARMs would largely mitigate the thrift industry's increasingly difficult dilemma of having long-term assets funded by short-term liabilities (savings deposits). This

ILLUSTRATION BY JEANNE TURNER

problem was particularly acute in the newly deregulated financial environment, where it was not uncommon for thrifts' short-term cost-of-funds to significantly exceed their yield on the mortgages held in portfolio. It was also thought that an additional advantage of ARMs would be their ability to survive periods of heavy refinancing.

ARM production

The popularity of ARMs engendered a push by lenders who relied on the sale of ARM production to secondary market agencies to have the agencies and the FHA make these products available for secondary sale. The agencies responded, but not aggressively. FHA offered a limited amount of ARM product that had characteristics that were not considered highly attractive. Fannie Mae began purchasing ARMs for portfolio in 1980. Subsequently, Fannie Mae, Freddie Mac and GNMA offered adjustable-rate mortgage-backed securities (MBS) backed by ARM product. MBSs have also been offered in a senior/subordinated structure, whereby the thrifts' retention of the junior piece in portfolio also served to insure the senior piece. Lately, the agencies have developed innovative MBS structures that offer better pricing for ARM product than heretofore had been available. Freddie Mac, for example, offers a weighted-average coupon (WAC) ARM program that has allowed mortgage lenders greater flexibility in the diversity of ARM products that can be pooled.

Of the approximately 185,000 residential loans originated by McDash participants last year, about 23,000 or 2.4 percent were ARMs.

Characteristics

ARMs have been offered in a variety of forms. The basic characteristics of all ARM loans are:

Initial rate—The note rate offered for an initial period, typically one year. When offered at an artificially low rate, it is usually referred to as a teaser rate.

Index—The market-determined interest rate that forms the basis for subsequent adjustments. The most popular indices are the Federal Home Loan Bank's eleventh district cost-of-funds and U.S. Treasury security constants.

Spread over index (margin)—The increment added to the index that is used to determine the note rate in all but the initial period. This margin typically ranges from 250 basis points to 300 basis points.

Lately, the agencies have developed innovative MBS structures that offer better pricing for ARM product than heretofore had been available.

Adjustment period—The interval between adjustments of the note rate. Adjustment intervals typically range from one month to five years.

Interest rate adjustment cap—The maximum allowable upward adjustment of the note rate in any single adjustment period, typically 1 to 2 percent per adjustment.

Life-of-loan rate-increase cap—The maximum allowable upward adjustment of the note rate over the life of the loan, usually 6 percent.

An additional feature of certain ARM programs is a convertibility option whereby the borrower can, at a pre-specified time, (for example, after 5 years), convert the loan to a fixed-rate instrument. The fixed rate attainable by the borrower at that time is typically specified as about a half point in excess of the market rate at the time of conversion. The existence of this feature has a number of ramifications, the most important of which is a lower anticipated prepayment rate.

Valuation

Techniques used in the valuation of ARM servicing portfolios are similar to those used to evaluate fixed-rate portfolios. The value of the portfolio is computed by projecting revenues, less expenses and taxes, adding in amortization (a non-cash expense) and computing the present value of the expected after-tax cash flows generated by the portfolio over its projected life.

The key differences among valuation parameters between ARMs and fixed-rate mortgages involve assumptions about run-off rates, servicing costs, foreclosure rates and servicing fees. In three of the four primary determinants of the portfolio's cash flow stream, ARMs are perceived to be significantly inferior to comparable fixed-rate product. ARMs are typically subject to higher prepayment rates (see Table 1), costlier to service and suffer higher delinquency/foreclosure rates (see Table 2).

These disadvantages are not offset by any concessions in the fourth major factor: servicing fees. ARM servicing fees are generally the same as that of their fixed-rate counterparts. As a result, the cash-flow value of ARM portfolios often comes to only 60 to 70 percent of the value of a comparable fixed-rate package, although in certain interest rate environments, the servicing on ARM loans can trade at less than 50 percent of the value of fixed-rate mortgage servicing.

There is some controversy about how quickly ARM loans pay off, but the general consensus is that ARMs pay off at a much more rapid rate than fixed-rate mortgages. There is anecdotal evidence that during the rapid decline in interest rates experienced in the early 1980s, ARM portfolios were paying off at approximately 33 percent per year. Most servicers did not anticipate the high rate of ARM prepayments and were shocked at the surge in prepayments in their ARM portfolios during the 1986 to 1987 refinance boom.

This was the result of a miscalculation of consumers' motives in choosing ARM financing. Rather than being satisfied with a reduction in their note rate (and monthly payment) when rates fell, many ARM borrowers preferred to lock into a fixed-rate loan. Also, borrowers who intended to relocate within two to three years chose to take advantage of teaser rate ARMs rather than commit to fixed-rate product, even in low interest rate environments. However, a substantial portion of ARM borrowers chose to keep their original ARMs; avoiding high refinancing costs while also experiencing a significant reduction in their note rate.

ARM behavior

There are a number of theories to explain the rapid payoff characteristics of ARMs. First, a flat or inverted yield curve would cause fully indexed ARM rates to approach or exceed the rates of fixed-rate mortgages. Because borrowers seem to have a strong, natural preference for fixed-rate financing, this would cause borrowers to refinance into fixed-rate mortgages.

Second, ARM indices, because they are based on averages, tend to lag rate movements when the yield curve shifts downward. During the last major bond rally that ended in early 1987, long-term rates fell so quickly that ARM borrowers found that it was possible to refinance into fixed-rate mortgages at a lower rate than what they were experiencing at the current, fully indexed rate.

Third, ARM borrowers are often more mobile. Many home purchasers who do not expect to remain in a house for more than two or three years find it more cost effective to borrow at an adjustable rate, especially if there is a teaser involved. They believe that by the time the rate adjusts they will have already moved on to a different home and a different mortgage loan.

Finally, under certain circumstances, the borrower may find it advantageous to pay off a fully indexed ARM and refinance into another adjustable-rate loan with an attractive teaser rate even if there are no plans to move. For example, one New England lender is currently offering a one-year ARM with an initial rate of 5.5 percent with a two/six cap. This attractive pricing creates a strong incentive for borrowers to refinance.

Another concern among servicers is the higher unit-servicing costs anticipated for ARMs, especially those with negative amortization, short adjustment intervals and the relatively few that have adjustable servicing fees. Early on, many firms had to process ARM loans manually. This resulted in a significantly higher unit-servicing cost. The unit-cost increment was estimated by some at an one-eighth of a point of outstanding principal balance. Today some servicers estimate that ARMs are no more costly to service than fixed-rate product, due to the enhancement of their systems to accommodate ARM requirements.

The majority, however, still believe that unit servicing costs are higher for ARMs than for a comparable fixed-rate loan. Many secondary servicing market participants estimate the difference to be about $15 per loan. Because the majority of ARM loans are newer and have high average balances, the added cost has had a relatively minimal impact on the present value of the servicing.

> ***Fears about ARMs' higher degree of vulnerability to foreclosure appear, in retrospect, to have been somewhat exaggerated.***

Servicers perceived potential foreclosure risks associated with ARMs early on. With sufficiently large increases in interest rates, the loan could become unaffordable for the borrower. This risk would be exacerbated if the borrower had been qualified for the loan at an artificially low teaser rate, as was increasingly the case in the mid-1980s. This entails calculating the borrower's ability to meet the monthly payment obligations on the basis of the teaser rate rather than the fully indexed rate. This problem is made worse in the case of negatively amortizing loans, which can eventually reduce the borrower's equity to zero—or less.

Fears about ARMs' higher degree of vulnerability to foreclosure appear, in retrospect, to have been somewhat exaggerated. Table 2 indicates that ARMs suffer foreclosure at a rate roughly double that of conventional fixed-rate product. This may be a function of payment shock associated with the ARM rate becoming fully indexed. This is es-

TABLE 1

McDash Analytics, Inc.
Annualized Paid-In-Fulls and Foreclosure Completed Rates by State
(Only First Mortgages, Fixed Rate & ARMs)
For Month-End April 1990 thru March 1991

	Conventional Fixed Rate			**Conventional ARMs**		
Age of loans (yrs)	**Average Loan Count**	**P/F Rate**	**FCC Rate**	**Average Loan Count**	**P/F Rate**	**FCC Rate**
Total USA-All ages	1,177,175	7.96%	0.30%	216,627	12.10%	0.95%
California	288,942	8.79%	0.05%	58,242	18.35%	0.18%
Florida	73,746	7.85%	0.37%	20,777	8.68%	1.69%
Massachusetts	61,549	6.25%	0.08%	10,740	7.76%	0.61%
New Jersey	60,203	6.35%	0.10%	10,300	8.36%	0.21%
New York	68,842	6.78%	0.06%	13,748	5.68%	0.62%
Texas	127,160	7.58%	1.08%	14,806	6.86%	3.88%

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TABLE 2

McDash Analytics, Inc.
Date as of March 31, 1991
RATIOS FOR THE MONTH OF MARCH, 1991

	CONVENTIONAL LOANS	
	FRMS	**ARMS**
LOAN COUNT	1,392,121	260,033
DELINQUENCY RATES		
1 Month	2.41%	3.30%
2 Month	.45%	.97%
3+ Months	.42%	1.01%
Total	**3.28%**	**5.28%**
IN FORECLOSURE	.43%	1.50%
IN BANKRUPTCY	.32%	.53%
Total	**.74%**	**2.03%**
Total Noncurrent	3.71%	6.78%
PAID IN FULLS		
Normal	.80%	1.37%
Foreclosures Completed	.03%	.10%
Total	**.83%**	**1.47%**

(Data Reprinted with Permission of McDash Analytics)

pecially a problem if the loan is underwritten on the basis of a teaser rate.

The conventional ARM foreclosure rate is still below that of fixed-rate FHA or VA mortgages. Nonetheless, there remains a fear that a sufficiently adverse interest-rate scenario could generate enough payment shock to cause severe ARM foreclosure problems.

Other factors that impact the valuation of ARM servicing are adjustable servicing fees, convertibility and liability resulting from improper rate adjustments. If the servicing fee fluctuates over time, this must be taken into account when modeling the cash flows. It is our experience that this added uncertainty is usually resolved to the detriment of the seller; the buyer will usually value the portfolio under the worst-case scenario (i.e. at the lowest available servicing fee).

Some ARMs are convertible to fixed-rate instruments. The likelihood is that if a potential purchaser viewed the probability of a conversion to be high, he or she would presumably modify the payoff assumption to reflect those currently being used for fixed-rate mortgages. Unfortunately, so little of this product exists, it is difficult to draw any hard conclusions about how the market actually modifies the evaluation.

Caveat ARM lender

An alarming rise in the number of lawsuits, including class-action suits, has occurred in the past few years based on incorrect ARM rate adjustments. One mortgage company settled a class-action suit for more than $1 million because a computer programmer used the wrong Treasury index from the list of key interest rates published by the Federal Reserve for ARM resets. The error was not discovered until an attorney for the borrowers brought it to the company's attention.

Houston-based Mortgage Consultants of America completed a number of ARM adjustment reviews in the past 12 months and reported an error ratio on ARM adjustments of 23 percent to 27 percent. Even though this ratio appears high, it must be noted that this percentage includes errors favorable to both the borrower and the lender. Of these errors, only about 8.5 percent were material errors requiring a mandated adjustment of more than $50.

Most errors result from the use of inaccurate or inappropriate indexes and incorrect adjustment dates that were found to result from set-up errors and general errors in the servicers' database documentation. Needless to say, when performing due diligence on an ARM servicing portfolio, it is important to analyze the adjustment calculations carefully.

The market

ARM servicing typically appears on the market as a segment of a larger overall portfolio. When separate, pure ARM portfolios do appear, they are typically agency product. Relatively little private investor ARM product is traded. A typical, entirely ARM servicing package would range between $50 million to $100 million in unpaid principal balance.

Although thrifts are by far the largest ARM producers, mortgage bankers are the primary sellers of ARM servicing. A great majority of ARM production volume was originated by thrifts for portfolio investment purposes and was not securitized.

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Thus, the percentage of total ARM mortgage debt outstanding that is easily tradeable on the secondary servicing market is relatively small, constituting only about 5 percent of servicing transfers, or about $7 billion of an estimated 1989 total servicing transfer volume of about $150 billion. Though thrifts also sell ARM servicing, they tend to sell only the servicing of securitized agency or Fannie Mae portfolio product. Because proceeds from the sale of servicing of whole loans in portfolio cannot be recognized up front, but must be booked over the life of the underlying asset, the sale of the servicing rights to thrifts' ARM loans held in portfolio is virtually never contemplated.

Typical ARM servicing buyers are large servicing operations or smaller shops that have developed specialized systems and therefore have a comparative advantage in servicing ARM product. Many firms do not have the systems in place to service ARMs efficiently. Also, the greater uncertainty regarding runoff, additional servicing costs and potential liability resulting from improper rate adjustments keeps many potential buyers on the sidelines.

Pricing

ARM servicing trades at significantly lower prices than comparable fixed-rate product, often selling for prices of only 60 to 70 percent of comparable fixed-rate servicing, depending on the interest rate environment. The major reason for this significant pricing difference appears to be the perceived higher prepayment risk of ARMs and, to a lesser extent, the servicing cost differential. Homogeneous packages of the more common ARMs with popular adjustment periods and indices (for example, one-year ARMs, indexed to Treasury bills), typically attain the best prices. Also, buyers offer higher prices for portfolios in certain geographic areas and for those with convertible options because they expect a lower prepayment rate. In terms of size, small- to medium-size packages of $50 million to $100 million have tended to get the best reception from the market.

-Prices for ARM servicing also are considerably more volatile than for fixed-rate product. ARM prices are extremely sensitive to anticipated prepayment rates, which in turn are greatly affected by the level of interest rates and the slope of the yield curve. For example, in the rising interest rate environment of early 1988, ARM portfolios attained prices of four times servicing fees (compared with the 4½ to 5½ times servicing fee multiple for fixed-rate portfolios.) However, when the yield curve flattened and then inverted in late 1988, ARM prices dropped to around two times servicing fees. Although prices for fixed-rate portfolios also fell somewhat, the percentage decline was nowhere near that experienced with ARMs.

By mid-1989, when the yield curve went from inverted to flat, ARM servicing prices went back to the 2½ to 3½ times servicing fee range. The fact that the ARM market is thinner, with fewer potential buyers than the fixed-rate market, also adds to its price volatility. ARM servicing typically sells for about two times service fee today.

ARM prices tend to strengthen when buyers anticipate relatively little runoff (i.e. when they perceive that interest rates will remain steady or rise)

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and when the yield curve is expected to remain positively sloped. On the other hand, abrupt interest rate declines or an inverted yield curve lead to a high level of ARM refinances. Buyers adjust by increasing their prepayment rate expectations, often to three or four times Public Securities Association (PSA) rate or more. The result is a drop in the value they place on ARM portfolios. A very steep, positively sloped yield curve can also cause prepayment concerns for ARM servicers, because a large spread between a fully indexed ARM interest rate and a current teaser rate may cause borrowers to refinance their existing ARMs into cheaper ARMs.

Conclusion

Since the mid-1980s, ARMs have constituted a large percentage of total, single-family mortgage loan origination volume. In high interest rate periods their share of the market often exceeds 50 percent. By some estimates, the ARM share of total single-family mortgage debt outstanding exceeds 20 percent.

Based on the McDash statistics in Table 1 and Table 2, one may conclude that in certain geographic areas, prepayment rates for ARMs are comparable to prepayment rates for fixed-rate mortgages. During the last 12 months, for example, New York and Texas experienced ARM payoffs at a rate that was actually less than that for fixed-rate mortgages. This data, of course, must be interpreted in light of the level and slope of the yield curve for that time period and the economic condition of the relevant geographic market.

Based on the last 12 months' prepayment data, it appears that for at least certain geographic areas, the market may be underestimating the average life of ARMs. To the extent that this is case, it seems reasonable to assume that an opportunity exists for those willing to commit the necessary resources to become efficient servicers of ARM loans and to develop the information needed to identify pricing anomalies in the marketplace. **MB**

Steven Z. Hoff is president and CEO of Hamilton, Carter, Smith Consulting Inc., based in Alexandria, Virginia. The preceding text is adapted from Adjustable Rate Mortgages and Mortgage-Backed Securities *published by Business One Erwin.*

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CANADA'S RISING STAR

The Canadian MBS is showing some real staying power, and investors are finding a lot to like about this thriving securities market.

Albert Warson

In little more than four years, the mortgage-backed securities (MBS) market in Canada has achieved growing stature in a way that seems impervious to the jarring shifts of the investment playing field.

MBS issues backed by the federal government of Canada have racked up sales of $5 billion from the time they were introduced in 1983 to the end of last year, according to Doug Hughes, a Canadian MBS expert. Despite 1991's lackluster market, sales as of May had already topped $6 billion.

Hughes is formerly the general manager of the Canada's Mortgage-Backed Securities Center operated by the Canada Mortgage and Housing Corporation (Cannie Mae), the federal government's housing agency located in Toronto. Cannie Mae is also the administrator for the Canadian mortgage-backed securities program. Thus, the agency may be described as a kind of Canadian hybrid of both FHA and GNMA in the United States.

Securitized, residential first-mortgage loans are insured by Cannie Mae and are originated by banks, trust companies, credit unions and mortgage brokers and are then combined into pools for sale to investors. Cannie Mae guarantees full and timely payment of principal and interest to the MBS investor. When MBS are issued, the mortgages are converted into fully guaranteed, flexible and liquid instruments. Each MBS represents an undivided interest in a pool of mortgages.

Although U.S. and Canadian mortgage-backed securities are structured in much the same way, there are differences in the standard mortgage terms and prepayment penalties (see Table 1).

Given the total $225 billion in Canadian residential mortgage loan debt, $6 billion in securitized debt is, comparatively speaking, insignificant. But at the rate MBS issued in Canada have skyrocketed—the growth curve practically forms a 45-degree angle—some industry sources' predictions that they will become the largest single source of residential loan funding by the year 2000 doesn't seem the least bit fanciful.

Meeting housing's need

In the early 1980s, the Canadian federal government saw that there was a pressing need to lower interest rates and help provide affordable housing for its citizens. During that period's 22 percent interest rate environment, Cannie Mae's role was expanded through an amendment of the National Housing Act (NHA) to provide the unconditional guarantee of timely payment when pools of government-insured mortgages were created. In taking this step, Cannie Mae looked to accomplish three broad objectives: to lower interest rates in general, to accomplish the return of long-term mortgage financing and to facilitate the smooth functioning of a secondary mortgage market.

In 1987, Cannie Mae began its guarantee program on MBS pools of residential, government-insured, first mortgage loans. Later the guarantee was expanded to include guarantees on MBS of two types of mortgages: regular and social housing pools. MBS on social housing pools were first issued in 1988, and they consist of mortgages of government-subsidized social housing projects. The key feature of these mortgages is the elimination of prepayment—making them an attractive security for investors.

Other parties had joined the MBS market as well. In 1985, GMC Investors Corporation in Toronto began issuing securities called Guaranteed Mortgage Certificates (GMC) that were guaranteed by Citibank Canada, a subsidiary of Citicorp. At that time, company President Ivan Wahl said that U.S. mortgage-backed securities had become the most popular investment instruments in Wall Street history and claimed that "the GMC will be as successful in Canada [as Ginnie Maes are in the U.S.]."

The GMCs had limited potential, but in general, mortgage-backed securities were catching on fast—especial-

TABLE 1

Comparison of U.S. and Canadian MB

	Ginnie Mae	Canadian MBS
Standard Mortgage Terms		
Standard term	30 years	5 years
Standard amortization	30 years	25 years
Principal due at maturity	0	94% of orig. balance
First prepayment date	Immediate	After 3 years
Prepayment Penalties		
Full prepayment	None	3 months interest
Partial prepayment:		
Amount allowed	Unlimited	10% minimum
Penalty	None	None

ly those carrying the Cannie Mae guarantee. Toronto-based FirstLine Trust, which Wahl now heads up, began issuing Cannie Mae-backed securities in 1987. Cannie Mae sources say sales have picked up steadily since then, and FirstLine issuances accounted for more than 30 percent of the total Canadian MBS issuance in 1990, according to Burns Fry, Limited, a Canadian investment firm.

Banks take the plunge too

The mortgage-backed securities market has seen a radical change in attitude on the part of investors in the last six months or so. For example, in an interview late last year, Wahl told *Mortgage Banking* that Canada's chartered banks were preoccupied with shaky, third-world real estate and corporate loans and only halfheartedly dabble in MBS. Cannie Mae data reflected that; at the end of 1990, trust companies held a 76.7 percent grip on investment market share. Banks had a 20.1 percent share, and life insurance companies had 3.2 percent share of investment.

Since then, however, banks have lunged into this investment pool with both feet. According to Cannie Mae, in February, banks' share of the market rose to 45.7 percent—nearly doubling in two months—and trust companies' share was reduced to 54.3 percent of the market for Cannie Mae-backed securities.

Why have the banks come alive so abruptly? Banks discovered that trust companies tended to stay away from MBS social housing pools. The banks were "stuffed with cash and realized they had to acquire assets, because loans on single-family housing had shrunk," said Hughes. Because banks were left with deposits they had to invest, they chose securities that backed mortgages on viable social housing projects where the mortgages were insured by Cannie Mae.

Therefore, rather than lose the business, banks have decided to take a 15 basis point spread, instead of the usual 200 basis points, Hughes said, and are now investing in social housing MBS to have those assets on their books. They can also use this investment to strengthen their community relations efforts.

Thus, what started as a program to provide shelter for low-income households has taken off as an attractive investment opportunity. In 1989, more than half a billion dollars in lower-cost financing for this housing sector was generated on the strength of its non-prepayable, fixed rate of return appeal to investors. Social housing pools provided bond equivalent yields of approximately 10.1 percent as of April 30, 1991. At year-end 1990, the percentage of social housing MBS was nearly half of the total government-backed issuances, with approximately $294 million issued in the fourth quarter alone, according to Cannie Mae (see Chart 1). Of the two types of MBS, prepayable and non-prepayable, the social housing mortgages fall into the non-prepayable MBS category. These can be compared to the government-insured prepayable MBS that provide for 10 percent prepayments on the principal at the first and second anniversaries of the mortgage and on any amount after the third anniversary. A three-month interest penalty is imposed, however, even on the prepayable mortgage.

Profile: FirstLine—a market leader

Several trust companies give FirstLine a competitive run in the prepayable market. On the other hand, Wahl says financial institutions, with huge staffs and overlapping layers of bureaucracies, "don't perceive MBS as a window of opportunity. They are not set up internally to make it worth the effort." FirstLine has designed its operations to track mortgage commitments, interest rate exposure, the bond market and many other administrative details, says Wahl. Its management says the company's success as an issuer of MBS is evidence that it has been well "worth the effort."

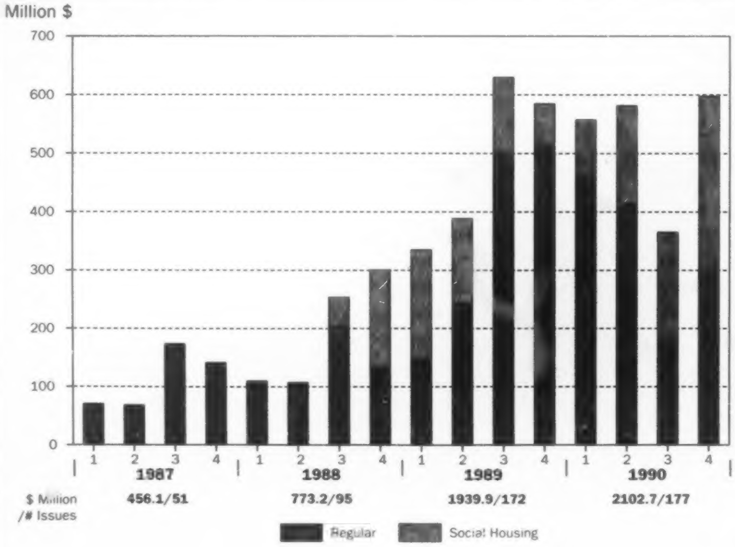
Wahl says FirstLine hopes to increase the size of its franchise network. Currently the network consists of 13 mortgage centers that originate product across Canada. Wahl plans on increasing the number of centers in the network to 50 by the end of 1991.

FirstLine also buys large blocks of mortgages from provincial govern-

CHART 1

Mortgage-Backed Securities

Inception–December 1990



TOTAL: **Reg: 3,772,034/313 + SH: 1,499,827/182 = 5,271,861/495**

ments that want to get out of non-profit rental housing loans. The company has purchased more than $460 million of these kinds of portfolios over the past three years from three provincial governments.

By charging 120 basis points as a yield on its investment vehicles such as its large mortgage portfolio, Wahl said FirstLine covers its overhead and makes a profit.

Market picture is bright

Cannie Mae data show that MBS produce higher yields than Government of Canada (GOC) bonds. During the third quarter of 1990, for example, the spread over GOC equivalent yields were 75 basis points for social housing (closed) MBS pools, 85 basis points for five-year, market residential (open) pools and 100 basis points for a 10-year term. Closed pools are those in which the borrower does not have the option to prepay principal. These securities, therefore, offer more predictable prepayment behavior, which makes them attractive to investors. Open pools consist of mortgages where the borrower has prepayment privileges, which are passed on to the investor when exercised.

Recent revisions to Cannie Mae-backed MBS include a fully open, 10-year, 10 percent rate buy-down mortgage that was marketed by a Toronto-area home builder in conjunction with the MBS program. (The usual Cannie Mae mortgage term is one to five years, with the first three years closed.)

In September 1990, Cannie Mae responded to market pressures and reduced the minimum eligible mortgage term for MBS. After lenders reported how popular these mortgages were with their customers, the Cannie Mae policy was changed so the term could be as low as six months, down from four-and-a-half years. This also had the effect of encouraging more capital market participants to originate funds at a lower cost. Are these shorter-length terms popular with investors? "Yes" says a source at Cannie Mae, although the shortest-term mortgage securitized as of this spring has been a 10-month term, according to the agency.

The wider range of terms in the Canadian secondary market is intended to stimulate efficiency and liquidity of mortgage markets by attracting more investors. The terms also help reduce interest rate risk for financial institutions, increase the number of issuers, make more mortgage funds available at lower rates and open up access to homeownership.

"MBS have been enormously successful in the United States over the past 20 years and in Canada over the past four. Even in the United Kingdom, where the approach to business is quite different, the building societies, as they call lenders over there, are beginning to wake up to their potential," says Wahl.

Canada is currently considering a number of programs and products for inclusion in the already proven and successful MBS program. Sales of Canadian MBS have ben noted domestically as well as in the United States, Hong Kong and other international markets. The future of this burgeoning market will no doubt be watched with interest by its financial market neighbor to the south, along with the rest of the world. **MB**

Albert Warson is a Toronto-based writer and editor specializing in real estate development issues.

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VITAL STATISTICS

KEY ECONOMIC INDICATORS AND INTEREST RATES

	CHANGES IN PAYROLL EMPLOYMENT (THOUSANDS)	UNEMPLOYMENT RATE (%)	CHANGES IN CONSUMER PRICES FROM YEAR AGO LEVELS (%)		MORTGAGE INTEREST RATES (%)		
			ALL ITEMS	ALL ITEMS LESS FOOD AND ENERGY	SECONDARY MARKET YIELD ON FHA NEW HOME MORTGAGES[1]	FHLMC ARMs	FHLMC FRMs
APR-90	55	5.4	4.7	4.8	10.53	8.55	10.37
MAY-90	440	5.3	4.4	4.8	10.49	8.59	10.48
JUN-90	212	5.3	4.7	4.9	10.21	8.49	10.16
JUL-90	−89	5.5	4.8	5.0	10.15	8.43	10.04
AUG-90	−127	5.6	5.6	5.5	10.20	8.35	10.10
SEP-90	−1	5.7	6.2	5.5	10.26	8.28	10.18
OCT-90	−180	5.7	6.3	5.3	10.24	8.21	10.18
NOV-90	−267	5.9	6.3	5.3	10.02	8.10	10.01
DEC-90	−161	6.1	6.1	5.2	9.74	7.93	9.67
JAN-91	−191	6.2	5.7	5.6	9.62	7.74	9.64
FEB-91	−286	6.5	5.3	5.6	9.58	7.65	9.37
MAR-91	−241	6.8	4.9	5.2	9.59	7.47	9.50
APR-91	−124	6.6	NA	NA	NA	7.38	9.49

RATES ON SELECTED SECURITIES (%)

	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT				A-Rated Utility
			6-Month	1-Year	3-Year	10-Year	
APR-90	8.26	8.30	7.84	8.40	8.78	8.79	10.09
MAY-90	8.18	8.25	7.76	8.32	8.69	8.76	10.04
JUN-90	8.29	8.14	7.63	8.10	8.40	8.48	9.85
JUL-90	8.15	7.99	7.52	7.94	8.26	8.47	9.96
AUG-90	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP-90	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT-90	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV-90	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC-90	7.31	7.80	6.70	7.05	7.47	8.08	9.95
JAN-91	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB-91	6.25	6.49	5.93	6.27	7.08	7.85	9.54
MAR-91	6.12	6.41	5.92	6.40	7.35	8.11	9.58
APR-91	5.19	6.07	5.71	6.24	7.23	8.04	9.46

CURRENT SECONDARY MARKET YIELDS (%)

SPREADS
(Basis Points)

	GNMA[2]	FNMA[2]	FHLMC[2]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
APR-90	10.01	9.94	9.94	122	115	115
MAY-90	9.99	9.93	9.92	123	117	116
JUN-90	9.73	9.73	9.72	125	125	124
JUL-90	9.66	9.66	9.66	119	119	119
AUG-90	9.80	9.75	9.75	105	100	100
SEP-90	9.86	9.79	9.73	97	90	84
OCT-90	9.84	9.80	9.69	112	108	97
NOV-90	9.63	9.66	9.54	124	127	115
DEC-90	9.22	9.27	9.16	114	119	108
JAN-91	9.17	9.24	9.12	108	115	103
FEB-91	8.81	8.86	8.77	96	101	92
MAR-91	9.00	9.03	8.93	89	92	82
APR-91	8.95	8.98	8.88	91	94	84

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit
(Millions of Dollars)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies
APR-90	35,407	7,543	12,400	15,122	28	1,973	145	935	698	50	18,984	100	621	14,796	3,048
MAY-90	37,255	9,420	13,183	14,231	27	2,453	297	1,061	874	39	15,412	110	640	10,905	2,657
JUN-90	38,428	9,714	13,209	15,063	29	2,778	209	989	682	182	16,411	105	666	12,303	3,097
JUL-90	35,524	9,627	12,020	13,461	30	2,082	165	871	696	209	16,222	98	476	12,525	2,984
AUG-90	35,777	10,359	12,940	12,032	34	2,582	106	950	1,243	92	18,967	107	650	14,783	2,994
SEP-90	34,210	9,825	10,617	13,347	36	2,008	178	855	608	112	20,231	102	577	16,100	3,343
OCT-90	35,229	12,128	11,317	11,395	37	1,719	41	843	606	28	13,941	99	551	10,049	3,041
NOV-90	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
APR-90	1,217	952	265	1,108	870	238	124	283	467	343	120	238	423	327
MAY-90	1,208	935	273	1,065	853	212	128	255	486	339	124	218	410	313
JUN-90	1,187	931	256	1,108	844	264	114	241	532	300	121	224	428	335
JUL-90	1,155	907	248	1,082	838	244	115	226	492	322	111	227	428	316
AUG-90	1,131	865	266	1,050	818	232	122	240	434	335	112	225	402	311
SEP-90	1,106	893	213	992	786	206	104	239	445	318	104	221	386	281
OCT-90	1,026	861	165	920	751	169	144	230	392	260	113	200	354	253
NOV-90	1,130	823	307	906	713	193	147	232	483	268	105	195	367	239
DEC-90	971	768	203	844	688	156	110	233	395	233	100	178	337	229
JAN-91	847	677	170	797	647	150	86	167	361	233	96	182	309	210
FEB-91	993	820	173	863	735	128	90	303	388	212	95	204	345	219
MAR-91	901	760	141	884	728	156	97	223	393	188	98	203	339	244
APR-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOME SALES

(Units and Prices in Thousands)

	EXISTING HOMES		NEW HOMES		
	Sold (SAAR)	Median Sales Price (Dollars)	Sold (SAAR)	Median Sales Price (Dollars)	Months Supply At Current Sales Rate
APR-90	3,370	95.7	534	130.0	8.3
MAY-90	3,350	95.2	535	125.0	8.2
JUN-90	3,370	98.9	549	125.0	7.9
JUL-90	3,320	98.1	541	118.7	8.0
AUG-90	3,410	97.2	525	118.4	8.1
SEP-90	3,160	94.4	504	113.0	8.4
OCT-90	3,070	92.9	465	120.0	8.7
NOV-90	3,150	92.0	480	118.9	8.2
DEC-90	3,130	91.7	464	127.0	8.4
JAN-91	2,900	95.6	409	120.0	9.4
FEB-91	3,160	94.0	485	120.0	8.0
MAR-91	3,180	96.5	490	125.0	7.5
APR-91	NA	NA	NA	NA	NA

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

	Total[5]	1-Unit	2+ Units	Nonresidential
APR-90	308.9	109.3	18.6	94.6
MAY-90	303.9	105.7	19.1	93.5
JUN-90	299.1	101.8	17.0	95.4
JUL-90	298.5	99.9	16.9	98.4
AUG-90	290.5	97.6	16.9	93.2
SEP-90	286.1	95.1	16.7	91.9
OCT-90	279.3	93.5	17.0	89.2
NOV-90	272.4	90.6	16.0	86.8
DEC-90	267.0	87.7	16.6	86.7
JAN-91	264.2	82.6	15.7	86.3
FEB-91	260.0	79.5	15.2	86.6
MAR-91	256.8	77.6	15.3	83.4
APR-91	NA	NA	NA	NA

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Securities for 0- to 30-day delivery.

[3] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[4] Savings & Loans and Mutual Savings Banks.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

JULY 1991

MORTGAGE BANKING

THE MAGAZINE
OF REAL ESTATE
FINANCE

TAKING
A COLD HARD LOOK
AT THE FUTURE

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JULY 1991 VOLUME 51 NUMBER 10

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Income Property

The commercial mortgage market is under heavy scrutiny. The regulators have descended on banks and thrifts to assess the extent of the damage. Real estate has a perception problem. We hope this issue will get behind the perception and probe the facts.

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COVER ILLUSTRATION BY SAM WARD

PORTFOLIO

Just the Facts

The industry is no doubt tired of the sensational headlines that have aggravated the chill that hangs over the commercial real estate market. The cumulative effect of countless stories about bank failures tied to real estate loans and developers in bankruptcy has made investors even more gun-shy than the facts warrant.

It is probably more important now than ever that the focus be on cold, hard, objective facts—devoid of emotional anecdotes about renegade regulators and huge inventories of thrift-financed, hollow office buildings. The pure unadulterated facts are critical to the turnaround artists who will chart the course of this recovery.

In this issue we tried to package some of the most pertinent facts we could find. Some of them will raise your eyebrows just a bit. Take, for example, this nugget: Currently there is more than one billion square feet of unoccupied office space in this country. That is more than the total existing office stock of the nation's largest market—the MidAtlantic region. The author of this article on the office market outlook says the overbuilding was so severe during the last decade, that "more than half of the U.S.'s 273 metropolitan and rural markets could absorb all of their predicted growth in demand for the next 10 years within vacant space that exists today."

The double whammy, of course, is that the already overbuilt office market is running smack up against a demographically induced decline in job growth—making the absorption process painfully slower. The actual numbers look like this: "Employment-driven demand for new office space will fall to 48 percent of 1980s levels, or 634 million square feet—much less than was constructed during the last 10 years in the South Atlantic and Pacific regions alone."

Those fickle demographics will turn against the multifamily market too. The bailout produced by seemingly endless waves of baby-boom renters will no longer allow projects to thrive that are not sound on the merits. Supply and demand will return as king, and it is demand, really, that will be calling the shots about what can and should be financed in the future. And the way our authors tell it—demand will be pretty hard to find in the 1990s.

Janet Reilley Hewitt
Editor in Chief

EDITOR'S NOTE: There were two errors in the May 1991 article titled "Appraising the Industry" by Vernon Martin III. The proportion of MAIs having bachelors or advanced degrees is 77.5 percent, as per the 1986 Membership Profile published by the American Institute of Real Estate Appraisers. Also, Home Savings of America is based in Irwindale, California.

COMING IN JULY

In August, we will review legislative action in the statehouses and in Washington D.C. that is of interest to mortgage bankers. We will also profile Freddie Mac's swat team of state legislative specialists.

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BPA

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THE RISE AND FALL OF THE U.S. OFFICE MARKET

The 1980s saw a one-time boom in office construction that will not likely happen again any time soon. Office demand will be radically reduced in this decade by a series of forces that are changing the kind of space sought and the regions where it will be located.

David Birch

ILLUSTRATION BY BETHANN THORNBURGH

More than 40 percent of all the office space ever constructed in the U.S. was built during the past 10 years, due to a series of trends that converged in the late 1970s and 1980s.

This era was marked by an internationalized economy and abundant capital, which fueled one of the biggest booms in U.S. real estate history. Commercial real estate, as a result, was one of the hottest businesses of the decade.

But the boom has ended; let there be no question about it. It seems that every day a new headline reads: "Bank Failure Linked to Real Estate Debt," "Construction Starts Down For Third Quarter," "Improving Your Odds....," "Breathing New Life into...." It is clear by now that the 1990s will be remembered in a very different way.

The opportunities for commercial real estate investment and development in the U.S. are rapidly changing.

CHART 1

Growth in White Collar Occupations

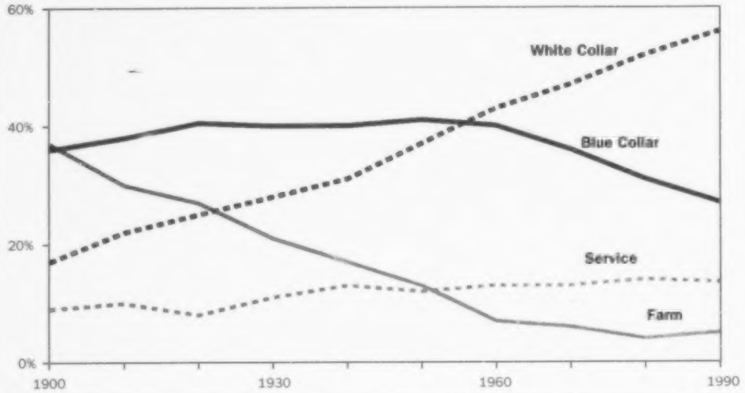
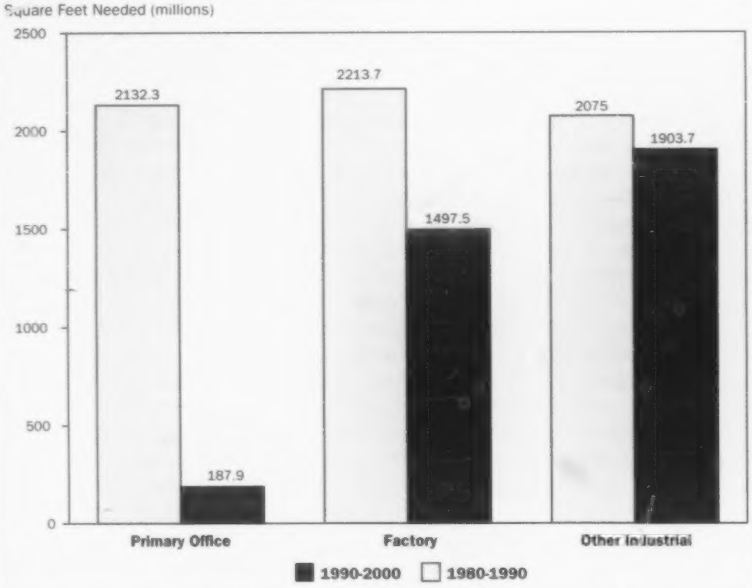


CHART 2

Past vs. Future Construction Need



Those factors that merged to produce the huge boom in the past 10 years will not be present for the next 10. What, then, is the outlook? Now that the rush is over, is there still any gold to be found?

Cognetics, Inc. a research firm based in Cambridge, Massachusetts, has been following the growth and decline patterns of the real estate market for quite some time. The firm recently completed two reports for the National Association of Industrial and Office Parks (NAIOP), the association for commercial real estate development, that provide quantified answers to these questions about what the outlook holds in store. Most recent is the report, "America's Future Office Space Needs: Preparing for the Year 2000." Using a unique forecasting capability based on studies of the actual growth trends of more than 8.3 million businesses, Cognetics has calculated past-versus-future demand for office and industrial space. Comparison of the results—by space type and by location—tells us a good deal about the realistic opportunities for commercial real estate investment and development through the year 2000. And perhaps more importantly, close consideration of the factors underlying the boom of the 1980s tells us a great deal about why it will not be repeated in the remainder of this century.

The bottom line is that the need for construction (including rehabilitation) of office and industrial space will decrease substantially in the next 10 years versus what it has been during the last 10. Not only will the overall rate of demand be lower; it will also be unevenly spread. Unlike the relatively universal demand of the 1980s, the demand of the 1990s will be limited to certain types and qualities of space and specific locations. But because those places and types of space will, in many cases, be very different from the ones most in demand in the 1980s, past performance will be a very poor predictor of future health. And because the factors that will define high versus-low-opportunity are neither simple nor obvious—and in many cases will have almost no direct relationship to real estate—new levels of information and sophistication will be required. In short, a new level of market intelligence regarding each area's scarcest resource—its tenants—will be a key element for success in the office market of the 1990s.

Market trends

To understand why the boom will not repeat, we must understand how it was created. Among the key trends are:

- absorption into the labor force of both the "baby-boom" generation and unprecedented numbers of working women;
- significant changes in the U.S. industry mix;
- major advances in business and office technology;
- increasing levels of international trade;
- skyrocketing rates of entrepreneurial activity.

Accompanying these major trends have been a number of subsidiary effects, including new roles for smaller businesses (often in unexpected industries), shifts in preference for particular types of geographic location and changes in the degree of competitiveness of U.S. industries.

To see how these diverse, and apparently unrelated, trends can have a tremendous impact on real estate demand, let's focus on one of the most powerful of them: the demographics of the baby boom.

The baby boom produced one of the sharpest increases in U.S. population growth ever experienced; the growth rate peaked at more than 20 percent in the early 1960s. But the boom was followed by a bust, and today, U.S. population growth is at its lowest level since the Great Depression.

In order to absorb the great mass of new baby-boom workers into the labor force, the economy had to produce substantial job growth. Not only that, but once the baby boomers—women, as well as men—became employed, they moved quickly into relatively high-paying jobs and became prodigious consumers, furthering the expansionary trend. Thus, this single, unique demographic effect can be cited as a primary catalyst for unprecedented economic growth in the U.S. during the 1970s and 1980s.

By comparison, there will be very few new workers to absorb into the economy in the 1990s. The growth in the U.S. labor force will drop from a high of 2.4 percent per year in the 1970s to only 1.1 percent per year in the 1990s. Absent a major change in immigration policy, there will be few new jobs to create, simply because virtually every American who wants to is already working.

While the baby boom was a major catalyst for economic growth in general, major shifts in the U.S. industry mix also affected the office market. As seen in Chart 1, the percent of the U.S. labor force employed in white-collar occupations has increased consistently—and dramatically—since the turn of the century. Whereas only 30 percent of Americans held white-collar positions at the outbreak of World War II, nearly 60 percent do today. But again, the trend has reached its peak. During the 1990s, white-collar employment will actually decline slightly as a percent of all U.S. jobs.

Construction demand drops

Demand for construction of commercial real estate will mirror the behavior of the economy, slowing down from the pace of the past 10 years. Even incorporating a conservative set of assumptions, the overall growth in need for construction of all three major types of space (primary office, factory and other industrial) will decline by an average of 45 percent versus the past 10 years—roughly in proportion to the rate of slowdown in total economic growth.

Furthermore, types of office commercial space will not be needed equally. The overall decrease in total construction demand masks declines that range from 9 percent to 93 percent for particular types of commercial space. And, as Chart 2 shows, it is the types of space that were most heavily constructed in the past 10 years that will be the least needed in the decade to come. In the most extreme case, the need for construction of new, primary office space will plummet to less than 10 percent of actual 1980-to-1990 construction levels. Less dramatically, the need for construction of factory space will fall to approximately two-thirds of recent past levels while need for other industrial space (including bulk distribution and flex/R&D/service center) will hold fairly steady at more than 90 percent of 1980-to-1990 construction levels.

The opportunities for commercial real estate investment and development in the U.S. are rapidly changing.

The outlook

The office market's outlook for the 1990s can be summarized by four key observations:

- The overall magnitude of growth in demand will be significantly lower than in the 1980s.
- Not all places will share equally.
- In many cases, the places that will do well in the future are quite different from the "hot" markets of the past.
- The degree to which individual locations are, or will become, overbuilt will have a tremendous impact on their viability.

At a most general level (and as previously cited trends would imply), growth in U.S. office employment in the 1990s will fall to just less than half of 1980s' levels. Whereas more than 4.8 million new office jobs were created in the last decade, the tally for the next decade is just less than 2.3 million. As a result, employment-driven demand for new office space will fall to 48 percent of 1980s' levels, or 634 million square feet—much less than what was constructed during the last 10 years in the South Atlantic and Pacific regions alone.

But in today's largely overbuilt market, the need for space and the need for construction of new space are not necessarily the same. A threefold increase in prevailing average vacancy rates during the past 10 years is symptomatic of the problem. Chart 3 indicates the enormity of today's oversupply. More than one billion square feet of unoccupied office space currently exists—more than the total existing stock of the nation's largest (Mid-Atlantic) market. As a consequence, more than half of this country's 273 metropolitan and rural markets could absorb all of their predicted growth in demand for the next 10 years within vacant space that exists today. Much like the credit-card-driven American consumer, the real estate industry has ransomed tomorrow's growth in order to build today.

But at the same time, the U.S. population is on the move, as seen in recently publicized reports from the U.S. Census Department. The upcoming labor shortage virtually ensures that the location preferences of employable people will dictate where businesses can create jobs and grow. As a result, future need for construction of office space will be very unevenly distributed among places (see Table 1). And the areas that will benefit most are those that are traditionally non-industrial, less expensive and warm. One-third of all employment growth in the 1990s will be located in just three states: California, Florida and Texas.

The South Atlantic region, which attracted only 20 percent of office construction in the 1980s, will account for a third of construction in the 1990s. Perhaps most shocking, the construction need in two of the nation's biggest regions for existing office space (New England and Mid-Atlantic), including the commercial centers of New York, Philadelphia, Hartford, Stamford and Boston, will be lower than in the small-based Mountain region, where there are not many firms relative to the size of the geographic area.

The biggest individual gainers in the 1990s will include many of the markets that "missed out" on the growth of the 1980s, whether because of severe industrial transitions or the effect of the world market for oil. Included here are recovering industrial cities, such as Canton and Erie and oil-patch areas such as Oklahoma City, Houston, Beaumont and Baton Rouge. On the basis of actual amount of office construction demand, Atlanta will lead the nation with a need for more than 10 million square feet.

But the U.S., as a whole, will need to restructure its office-space market. Even the most liberal scenario produces a rate of construction need that is two-thirds lower than the 2.132 billion square feet built in the U.S. in the 1980s.

The two factors that may work to boost office construction demand in the 1990s are:

- the market's ability to tolerate sustained, high vacancy rates, and
- the need for obsolescence-based construction.

That is, if the markets are willing and able to sustain vacancy rates that are well above the historical tight markets of 6 percent or 7 percent, then the need for office space construction could rise substantially. If the 1990s vacancy rates continue at the 1980 to 1990 average, for example, construction need would approach 500 million square feet. Similarly, if some existing buildings are deemed unusable because of obsolescent technology, location or design, replacement construction could be required.

> **The biggest individual gainers in the 1990s will include many of the markets that "missed out" on the growth of the 1980s.**

Looking forward

In discussing the requirements for successful commercial real estate investment and development in the 1990s, a final thought is in order: the level of demand is not the only aspect that is going to change. For office as well as industrial space, a changing tenant mix will create new challenges for developers and managers alike. Gone are the days when the prime industrial or office tenants were solely Fortune 500 firms. Today's growth companies are smaller, but are often just as sophisticated and demanding as the previous generation of major tenants.

With this in mind, we can point to three key success factors for commercial real estate investors in the 1990s:

Select your sites very carefully.—Growth will be highly selective—not only within regions, but within individual metro areas.

Buildings must be managed with great care.—Tenants will be the commodity of the future and smaller tenants will dominate demand.

Be informed.—In a more competitive marketplace, the best performers will be the best informed.

In the 1990s, success will be a matter of capabilities, not of luck. For the real estate player who selects his or her sites carefully, and comes properly equipped, the opportunities will be there. **MB**

David Birch is president of Cognetics, Inc., a Cambridge, Massachusetts-based marketing and consulting firm and is a faculty member at the Massachusetts Institute of Technology (MIT). This article is based on the findings from the report "America's Future Office Space Needs: Preparing for the Year 2000," commissioned by NAIOP. The author served as the primary researcher and Price Waterhouse provided the principal research grant for this study.

TABLE 1

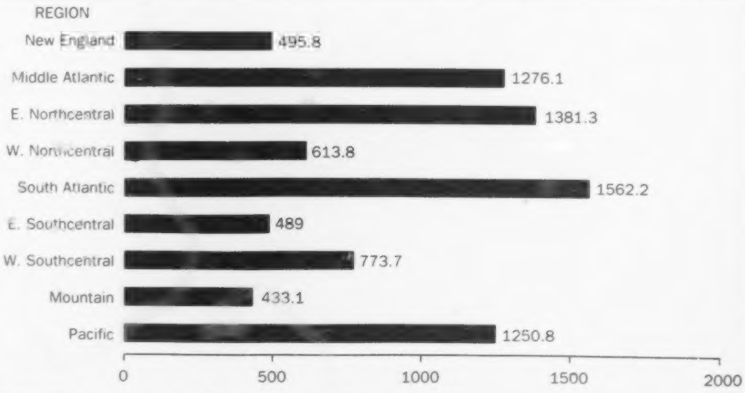
Expected Need for Primary Office Construction: Last 10 Years, Next 10 Years, Ratio of Future/Past
(Conservative Scenario: 6% Vacancy)

Area	Future	Past	Future/ Past Ratio
New England	3.9	148.8	.03
Middle Atlantic	7.6	368.4	.02
East Northcentral	15.8	259.3	.06
West Northcentral	7.3	136.9	.05
South Atlantic	46.1	444.9	.10
East Southcentral	5.3	79.1	.07
West Southcentral	5.4	302.6	.03
Mountain	13.0	118.0	[illegible]
Pacific	33.4	373.3	[illegible]
United States	137.9	2,132.3	.06

(Square feet in millions)

CHART 3

Regional Breakdown of Vacant Primary Office Space: 1990



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ECONOMIC TRENDS

In the first quarter of 1991, the delinquency rate for mortgage loans on one- to four-unit residential properties rose to 4.95 percent—up 24 basis points from the fourth quarter of 1990 and 54 basis points from the first quarter of last year. The percent of loans in foreclosure also rose, to 0.97 percent in the first quarter of 1991 from 0.94 percent in the fourth quarter.

These increases were not surprising in light of national economic developments. Even before the economy tipped into recession in July 1990, economic growth was very modest and home price appreciation was sluggish—factors that contribute to rising delinquency and foreclosure problems. Once the downturn began, these factors worsened and the unemployment rate began rising rapidly. Obviously, many borrowers have difficulty meeting mortgage payments when they have lost their jobs.

While the general economic deterioration accompanying the recession affected all regions to some extent during the past year, the impacts were not uniform. Table 1 shows regional patterns in mortgage delinquencies and foreclosures.

Compared to year-earlier levels, the Northeast showed the second-largest increase in delinquency rates of all regions, but the largest increase by far in the percent of loans in foreclosure. The pronounced increase in foreclosure partly reflected the fact that the New England (Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont) economy weakened significantly before the recession began; then was hit by broad-based national economic weakness to boot. That pattern, coupled with declining homes prices in some major markets, created conditions conducive to rising loan problems. Even so, New England still had levels of problem loans that were a bit below the national averages.

TABLE 1

		First Quarter 1991		Change from First Quarter 1990 (Percentage Points)	
		Delinquency Rate	Percent of Loans in Foreclosure	Delinquency Rate	Percent of Loans in Foreclosure
Northeast:	New England	4.02	.98	.81	.61
	Mid Atlantic	4.74	1.15	.62	.25
Midwest:	East North Central	4.79	.92	.28	–.04
	West North Central	3.79	.88	.31	–.07
South:	South Atlantic	5.25	.98	1.02	.13
	East South Central	6.37	1.00	.77	–.03
	West South Central	6.10	1.61	.12	–.20
West:	Mountain	5.08	1.47	.24	–.31
	Pacific	3.29	.44	.30	–.16

The Mid-Atlantic states (New Jersey, New York and Pennsylvania) experienced similar, but not quite as severe, increases in problem loans.

Meanwhile, the Midwest fared pretty well. In both the East North Central (Illinois, Indiana, Michigan, Ohio and Wisconsin) and West North Central (Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota and South Dakota) regions, delinquency rates rose relatively modestly, while the percent of loans in foreclosure actually fell. The reasons are straightforward. The economies of the states in the Midwest are weathering the recession fairly well, and home prices, which did not surge during the mid- to late-1980s as they did in other parts of the country, have continued to rise modestly, not fall.

In the South, there was significant diversity. In the South Atlantic region (Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia and West Virginia), the delinquency rate rose more than any other region. These eastern seaboard states are experiencing some of the same disproportionate slowdown that has plagued the Northeast. Further, the national weakness in the housing sector hit some of these states extremely hard because housing-related manufacturing (e.g., furniture, carpeting, etc.) is concentrated in some of these states.

On the other hand, another part of the South—the West South Central region, which includes Arkansas, Louisiana, Oklahoma and Texas—had the smallest increase in their delinquency rate and one of the largest decreases in the percent of loans in foreclosure. The reason is that the energy states are gradually coming back from the extremely depressed conditions of the mid-1980s—depressed conditions brought about by the collapse of energy prices.

The final region in the South—the East South Central region, which includes Alabama, Kentucky, Mississippi and Tennessee—fared somewhere in between the other two regions in the South. The delinquency rate went up sharply, but the percent for loans in foreclosure declined modestly.

The West, as a whole, performed relatively well. In both the Mountain (Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah and Wyoming) and the Pacific (Alaska, California, Hawaii, Oregon and Washington) regions, delinquency rates rose very little and the percent of loans in foreclosure fell. Part of the explanation is that rapid home price appreciation in a number of these states in recent years created a substantial equity buffer. The fact remains that equity is the single most important factor in mitigating loan problems generally, and foreclosures in particular.

Tom Holloway
Senior Economist

VITAL STATISTICS

KEY ECONOMIC INDICATORS AND INTEREST RATES

	CHANGES IN PAYROLL EMPLOYMENT (THOUSANDS)	UNEMPLOYMENT RATE (%)	CHANGES IN CONSUMER PRICES FROM YEAR AGO LEVELS (%)		MORTGAGE INTEREST RATES (%)		
					SECONDARY MARKET YIELD ON FHA NEW HOME MORTGAGES[1]	FHLMC	
			ALL ITEMS	ALL ITEMS LESS FOOD AND ENERGY		ARMs	FRMs
MAY-90	440	5.3	4.4	4.8	10.49	8.59	10.48
JUN-90	212	5.3	4.7	4.9	10.21	8.49	10.16
JUL-90	−89	5.5	4.8	5.0	10.15	8.43	10.04
AUG-90	−127	5.6	5.6	5.5	10.20	8.35	10.10
SEP-90	−1	5.7	6.2	5.5	10.26	8.28	10.18
OCT-90	−180	5.7	6.3	5.3	10.24	8.21	10.18
NOV-90	−267	5.9	6.3	5.3	10.02	8.10	10.01
DEC-90	−161	6.1	6.1	5.2	9.74	7.93	9.67
JAN-91	−191	6.2	5.7	5.6	9.62	7.74	9.64
FEB-91	−286	6.5	5.3	5.6	9.58	7.65	9.37
MAR-91	−241	6.8	4.9	5.2	9.59	7.47	9.50
APR-91	−124	6.6	4.9	5.1	NA	7.38	9.49
MAY-91	NA	NA	NA	NA	NA	7.22	9.47

RATES ON SELECTED SECURITIES (%)

	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT				A-Rated Utility
			6-Month	1-Year	3-Year	10-Year	
MAY-90	8.18	8.25	7.76	8.32	8.69	8.76	10.04
JUN-90	8.29	8.14	7.63	8.10	8.40	8.48	9.85
JUL-90	8.15	7.99	7.52	7.94	8.26	8.47	9.96
AUG-90	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP-90	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT-90	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV-90	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC-90	7.31	7.80	6.70	7.05	7.47	8.08	9.95
JAN-91	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB-91	6.25	6.49	5.93	6.27	7.08	7.85	9.54
MAR-91	6.12	6.41	5.92	6.40	7.35	8.11	9.58
APR-91	5.91	6.07	5.71	6.24	7.23	8.04	9.46
MAY-91	5.78	5.92	5.61	6.13	7.12	8.07	9.45

CURRENT SECONDARY MARKET YIELDS (%)

SPREADS
(Basis Points)

	GNMA^2	FNMA^2	FHLMC^2	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
MAY-90	9.99	9.93	9.92	123	117	116
JUN-90	9.73	9.73	9.72	125	125	124
JUL-90	9.66	9.66	9.66	119	119	119
AUG-90	9.80	9.75	9.75	105	100	100
SEP-90	9.86	9.79	9.73	97	90	84
OCT-90	9.84	9.80	9.69	112	108	97
NOV-90	9.63	9.66	9.54	124	127	115
DEC-90	9.22	9.27	9.16	114	119	108
JAN-91	9.17	9.24	9.12	108	115	103
FEB-91	8.81	8.86	8.77	96	101	92
MAR-91	9.00	9.03	8.93	89	92	82
APR-91	8.95	8.98	8.88	91	94	84
MAY-91	8.94	8.95	8.86	87	88	79

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit
(Millions of Dollars)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total^3	Mortgage Bankers	Savings & Loans^4	Commercial Banks	Life Companies	Total^3	Mortgage Bankers	Savings & Loans^4	Commercial Banks	Life Companies	Total^3	Mortgage Bankers	Savings & Loans^4	Commercial Banks	Life Companies
MAY-90	37,255	9,420	13,183	14,231	27	2,453	297	1,061	874	39	15,412	110	640	10,905	2,657
JUN-90	38,428	9,714	13,209	15,063	29	2,778	209	989	682	182	16,411	105	666	12,303	3,097
JUL-90	35,524	9,627	12,020	13,461	30	2,082	165	871	696	209	16,222	98	476	12,525	2,984
AUG-90	35,777	10,359	12,940	12,032	34	2,582	106	950	1,243	92	18,967	107	650	14,783	2,994
SEP-90	34,210	9,825	10,617	13,347	36	2,008	178	855	608	112	20,231	102	577	16,100	3,343
OCT-90	35,229	12,128	11,317	11,395	37	1,719	41	843	606	28	13,941	99	551	10,049	3,041
NOV-90	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
MAY-90	1,208	935	273	1,088	859	229	128	255	486	339	126	222	416	324
JUN-90	1,187	931	256	1,123	850	273	114	241	532	300	124	229	425	345
JUL-90	1,155	907	248	1,086	839	247	115	226	492	322	115	228	421	322
AUG-90	1,131	865	266	1,055	817	238	122	240	434	335	114	221	405	315
SEP-90	1,106	893	213	989	778	211	104	239	445	318	111	218	385	275
OCT-90	1,026	861	165	925	747	178	144	230	392	260	114	194	360	257
NOV-90	1,130	823	307	916	710	206	147	232	483	268	108	194	366	248
DEC-90	971	768	203	854	689	165	110	233	395	233	99	181	338	236
JAN-91	847	677	170	802	651	151	86	167	361	233	96	188	306	212
FEB-91	992	825	167	876	739	137	91	301	384	216	99	205	353	219
MAR-91	901	762	139	892	734	158	98	224	389	190	96	204	340	252
APR-91	957	819	138	913	787	126	96	231	392	238	102	210	361	240
MAY-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOME SALES

(Units and Prices in Thousands)

	EXISTING HOMES		NEW HOMES		
	Sold (SAAR)	Median Sales Price (Dollars)	Sold (SAAR)	Median Sales Price (Dollars)	Months Supply At Current Sales Rate
MAY-90	3,350	95.2	535	125.0	8.2
JUN-90	3,370	98.9	549	125.0	7.9
JUL-90	3,320	98.1	541	118.7	8.0
AUG-90	3,410	97.2	525	118.4	8.1
SEP-90	3,160	94.4	504	113.0	8.4
OCT-90	3,070	92.9	465	120.0	8.7
NOV-90	3,150	92.0	480	118.9	8.2
DEC-90	3,130	91.7	464	127.0	8.4
JAN-91	2,900	95.6	414	117.9	9.3
FEB-91	3,160	94.0	489	120.0	8.0
MAR-91	3,220	98.2	494	123.3	7.4
APR-91	3,330	102.0	500	122.0	7.4
MAY-91	NA	NA	NA	NA	NA

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

	Total[5]	1-Unit	2+ Units	Nonresidential
MAY-90	303.9	105.7	19.1	93.5
JUN-90	299.1	101.8	17.0	95.4
JUL-90	298.5	99.9	16.9	98.4
AUG-90	290.5	97.6	16.9	93.2
SEP-90	286.1	95.1	16.7	91.9
OCT-90	279.3	93.5	17.0	89.2
NOV-90	272.4	90.6	16.0	86.8
DEC-90	267.0	87.7	16.6	86.7
JAN-91	264.2	82.9	15.7	86.3
FEB-91	259.5	80.1	15.1	86.7
MAR-91	254.9	77.9	15.0	82.9
APR-91	257.4	78.8	13.1	86.2
MAY-91	NA	NA	NA	NA

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Securities for 0- to 30-day delivery.

[3] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

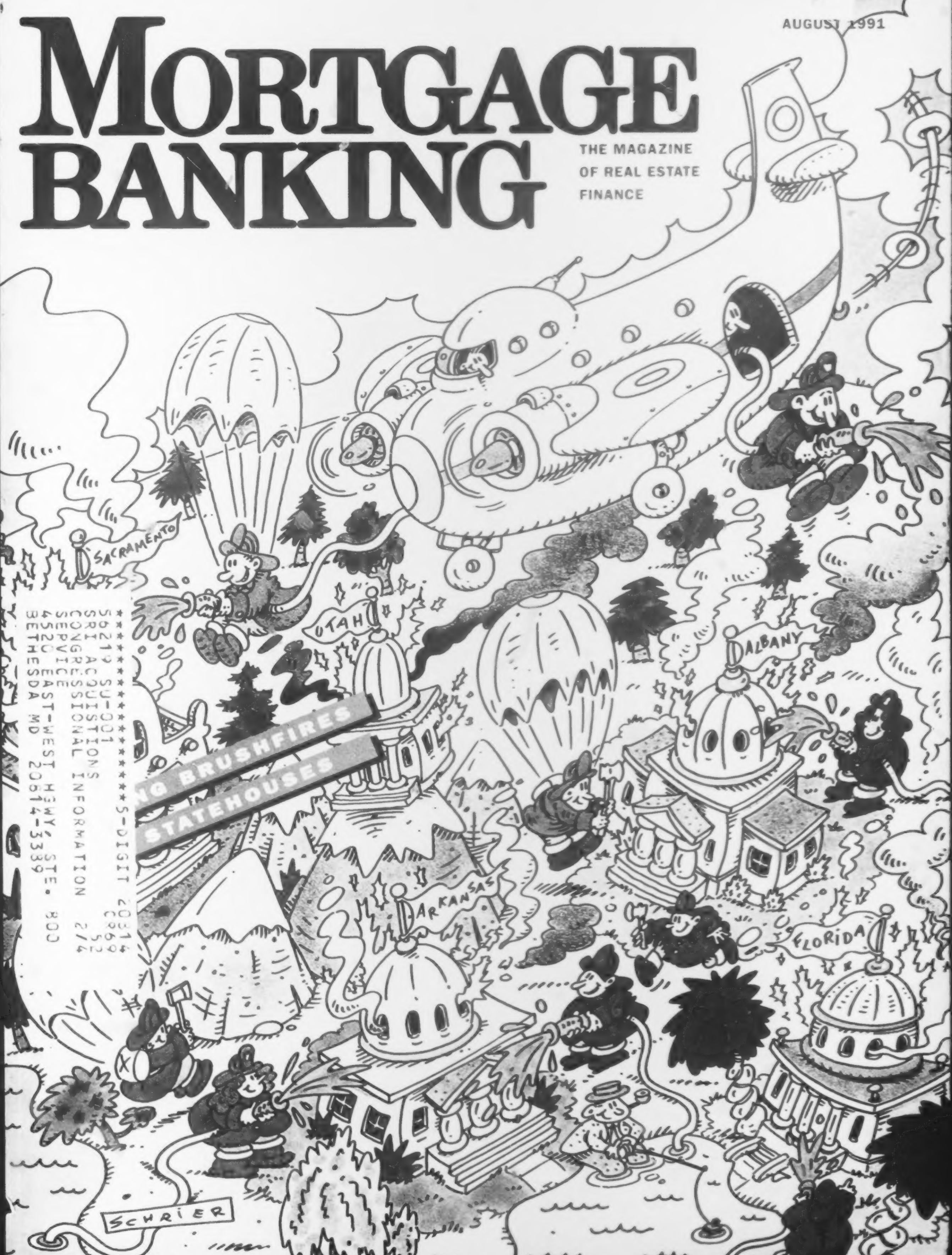
[4] Savings & Loans and Mutual Savings Banks.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

AUGUST 1991

MORTGAGE BANKING

THE MAGAZINE
OF REAL ESTATE
FINANCE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CONTENTS

AUGUST 1991 VOLUME 51 NUMBER 11

COVER:
Legislation

The states have emerged as a crucial new legislative battleground for mortgage companies trying to compete nationwide. Statehouses around the country are continually passing laws to license mortgage bankers and brokers or adding nuances to old laws that make them much more than mere licensing vehicles. As a result, the legislative brushfires that must be doused every year have left the industry's lawyers with little down time.

6.500 1 year treasury
.250 margin
6.750
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COVER ILLUSTRATION BY FRED SCHRIER

PORTFOLIO

Smoke Jumping

The industry's legislative firefighters got a good deal of extra time on the front lines this year, particularly in places such as Sacramento and Albany. A unique deadline put a federal statute that has produced major progress in the private secondary market on the line in many key states.

In New York and California and elsewhere, lawmakers have been deciding just how risky mortgage securities are as an investment for insurance companies operating in their boundaries. The states were empowered to reverse a decision made by their federal brethren back in 1984, that top-rated MBS and certainly Fannie Mae and Freddie Mac securities are highly desirable and secure investments.

The U.S. Congress back then tipped its hat to the concept of state's rights and self-determination and gave the states until October 3 to override a federal law called the Secondary Mortgage Market Enhancement Act. Who would have known then that the deadline would come due right on the heels of a historic bust of the thrift [illegible] and a real estate recession that has made real estate synonymous with [illegible] swamp land in the eyes of large insurance companies. Yet, this is the exact moment when we find the states faced with a decision on whether to concur with the U.S. Congress, which back in 1984 said the right policy decision is to channel more capital into the mortgage capital markets. What's at stake here is what will happen if we replace what has been a highly successful experiment founded on a single, uniform law, with an unpromising return to a patchwork of state laws that no doubt will curtail growth in the jumbo secondary market.

This is but one of the statehouse battles that is being fought this year on the industry's behalf by teams of expert advocates. Many of these unseen battles will shape the way the industry works or doesn't work in the future.

Janet Reilley Hewitt
Editor in Chief

COMING IN SEPTEMBER

The September issue will focus on how accounting has become king in the mortgage business. The accounting standard setters have had their say an now it's time to hear what some mortgage bankers have to say about th counting rules they most love to hate.

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CROSSING THE RUBICON

KPMG Peat Marwick's 1990 servicing performance study shows participants passed the $100-per-loan threshold on core cost. Here's the rest of the story behind this milestone.

Linda C. Simmons and Michele M. Long

The $94 core servicing cost reported in KPMG Peat Marwick's 1989 Mortgage Servicing Performance Study (MSPS) reflected a decrease in the cost of customer service, an increase in the cost of collection and foreclosure and a subsequent decrease in total servicing cost. The results suggested that the 1990 core servicing cost could go either way. The challenge for the 1990s was on.

> *"...Ancient history has it that it was considered an act of treason to enter Italy proper with an army over the Rubicon River. Of course, Julius Caesar did just that in 49 B.C. Since then, crossing the Rubicon is associated with making a statement...and dealing with the consequences..."*
>
> *unknown undergraduate,*
> *final exam, History 103*

The 1990 Mortgage Servicing Performance Study (MSPS) produced a weighted-average core cost of nearly $109 per loan. Participants in this year's study crossed the mythical servicing-cost Rubicon, reporting a 15 percent increase in core cost and a 17 percent increase in total cost (excluding amortization). The core-cost increase reflected the volume of difficulties in the industry; the total-cost increase was clearly a result of the cost of carrying these difficulties.

Notably, crossing the $100-per-loan threshold was done amidst significant efforts to keep costs down. Noticeable changes in organizational structure, increased use of outsourcing, enhanced preservicing acquisition scrutiny and planning and investment in voice-response units, autodialers, imaging and other technology were but a few of the projects aimed at managing servicing core costs. There were noticeable differences between those functional areas where core costs benefit from increases in volume and those functional areas where core costs rise with added volume.

The KPMG Peat Marwick fifth annual MSPS covered more than 3 million loans with a dollar volume of $204 billion serviced. The average portfolio serviced per participant was more than 196,000 loans with an average balance of close to $70,000 per loan.

Data collection was focused on personnel (salaries, benefits, incentives and the like), operating (outsourced and non-reimbursed) expenses and other operating (occupancy, utilities and so forth) costs. Full-time equivalent (FTE) management and staffing were measured for productivity purposes. Noncore costs, performance and profitability results were derived from balance-sheet and income-statement information.

Portfolio characteristics were gathered to reflect industry trends and the impact of previous results on core cost. The increasing number of repeat participants coupled with participants new to the study provided a wealth of data for the fifth and most unique analyses.

The big picture

The weighted-average core cost, or the direct cost of servicing a residential mortgage loan across this database of 3 million loans was $108.68, or $109 per loan. The $15 or 16 percent increase over the average core cost finding under the 1989 study occurred also entirely within the collections and foreclosure function ($12, or 46 percent more than 1989) and ancillary functions ($4, or 15 percent over 1989). A 4 percent reduction in the cost of customer service was nearly offset by a 3 percent rise in the cost of investor services.

In 1990, ancillary functions, which include general administration, data processing and the like, displaced customer service as the second-largest component of core cost. A comparison of the 1989 and 1990 core cost functional breakdown is presented in Chart 1.

The problems of delinquent loans were clearly reflected in total costs. The total servicing cost, which includes the core cost, loan losses, interest expense on advances plus indirect overhead, was $174 per loan, excluding amortization. This represents a $30, or 21 percent increase over 1989 results. In addition to the $15 increase in core cost, participants experienced a $10-per-loan increase in interest expense (a rise of 145 percent) over 1989, plus a $6-per-loan increase in loan losses. Indirect overhead allocation decreased compared to 1989. The relative distribution of 1989 and 1990 total servicing costs is shown in Chart 2.

Cost: at the crossroads

1990 core cost, as a percentage of total servicing costs, decreased over 1989's findings in that regard, suggesting that participants were better able to manage their direct costs. Inflation appeared to have minimal impact on 1990 core costs. Both personnel and other operating costs decreased as a percentage of core cost compared to 1989, as shown in Chart 3.

> **Crossing the $100-per-loan-threshold was done amidst significant efforts to keep costs down.**

Personnel costs per loan increased $5 per loan over 1989. This finding was a reflection of participant geography, rather than inflation or additional staffing. Personnel cost per FTE had a significant impact on overall core costs and was a relatively good predictor of core cost.

The increase in operating costs as a percentage of core cost (from 30 percent to 39 percent) suggested that the 1990 participants used more outside services in 1990. The $14-per-loan increase was supported by added costs in the foreclosure and real-estate owned (REO) functional areas, which experienced the most significant increases in operating costs.

Participants did an admirable job of controlling their other operating costs. Occupancy, telephone, postage and the like, experienced a $4-per-loan decrease.

Analysis of the 19 functional areas show that some trends isolated in past surveys are continuing, while the most recent results also show some new issues have emerged.

Five functional areas—foreclosure, data processing, REO, customer inquiry and general administration—accounted for 58 percent of core cost. In 1989, data processing, REO, general

CHART 1

Comparison of Core Cost-Functional Breakdown

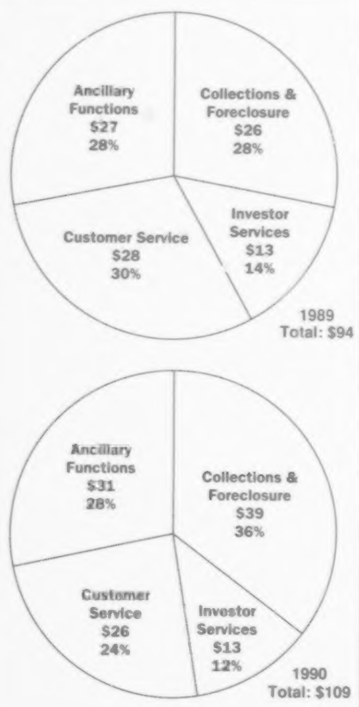


CHART 2

Distribution of Total Servicing Costs

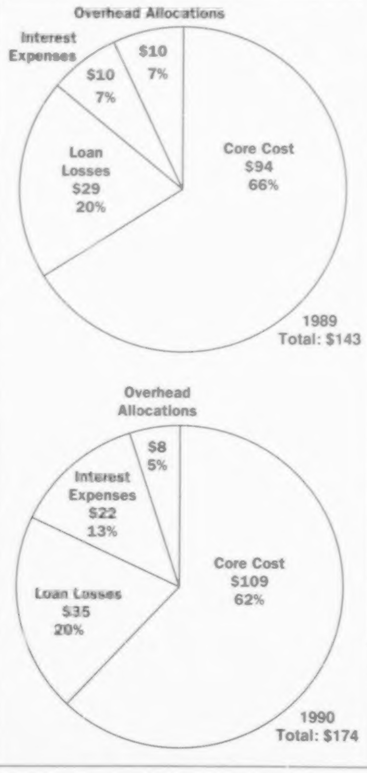
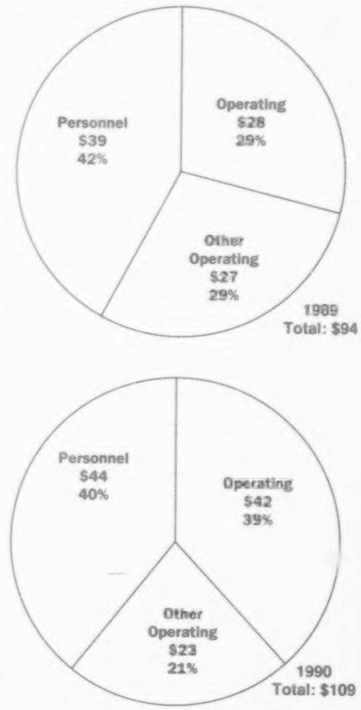


CHART 3

Personnel, Operating, Other Operating Cost Breakdown



administration, customer inquiry and collections accounted for 51 percent of the core servicing cost.

For the third consecutive year, the cost of customer service dropped, both as a percentage of core cost and in absolute dollars. The insurance function experienced the largest cost decline compared to 1989, followed by decreases in the tax, payoff and assumption functional areas.

The cost of servicing acquisition and special loans (including ARM adjustments) more than doubled over 1989 costs. Bankruptcy costs increased 40 percent compared to 1989 levels, although there was no relationship between bankruptcy ratios (the ratio of bankruptcies to total loans in the portfolio) and bankruptcy core cost.

Performance measures took a decided turn downward in the 1990 survey findings. For the fifth year, the average monthly number of loans serviced per FTE was a good predictor of core cost. However, the 1990 monthly average number of loans serviced per FTE of 630 reflects a decrease of 5 percent over 1989's average.

Surprisingly, the increase in collection and foreclosure costs was not reflected in increased staffing levels. For the third consecutive year, collection and foreclosure staffing levels declined as a percentage of total FTEs.

Turnover averaged 34 percent, an increase over 1989's ratio of 31 percent. Total turnover, as well as turnover by functional area, was not a predictor of core cost in the 1990 study.

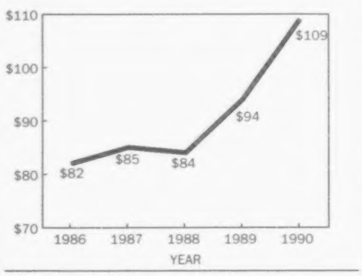
There was no apparent trend between span of control (staff to management ratios) and overall core costs.

In 1990, lower cost meant less

In the 1990 study, some of the most significant differences among servicing costs occurred between participant groupings of "low-," "mid-" and "high-" cost servicers, as calculated by their deviation from the weighted-average cost.

CHART 4

Average Servicing Costs



Participants in this year's study crossed the mythical servicing-cost Rubicon, reporting a 15 percent increase in core cost and a 17 percent increase in total cost.

One of the most revealing facts was that the low-cost servicers had lower costs in each of the five largest functional areas: foreclosure, data processing, REO, customer inquiry and collections; however, the same servicers were not lower cost across all 19 functional areas. Conversely, the high-cost servicers were not the higher cost finishers across all functional areas, although they were the higher cost servicers for the five largest functional areas.

Some other characteristics that distinguished low-cost servicers from high-cost servicers included:

- Collections and foreclosure expenses accounted for 29 percent of core costs for the low-cost servicers. High-cost servicers, on the other hand, had 42 percent of their core costs coming from the collections and foreclosure area. Low-cost servicers had lower average delinquency, foreclosure and REO rates than high-cost servicers.
- Nearly 68 percent of foreclosure costs for the mid- and high-cost servicers were associated with outsourcing—the use of an outside provider of a particular service. The low-cost servicers incurred only 27 percent of their foreclosure costs with outside vendors. This suggests that low-cost servicers are doing more of the foreclosure processing themselves and managing their outside relationships more closely. Productivity results support this observation as foreclosures per FTE were about the same for low-, mid- and high-cost servicers.
- Although bankruptcy core costs were linear, bankruptcy ratios did not mirror bankruptcy core costs. It might seem reasonable that as costs rise there would be a corresponding rise in bankruptcies, but the 1990 MSPS did not find that to be true. Again, it appears that lower-cost servicers are performing more of the processing themselves and managing outside vendors, such as attorneys, more closely.
- REO costs clearly distinguished low-cost servicers from high-cost servicers. The low-cost servicers generally had REO rates significantly below average and thus also had lower costs in this area. Furthermore, many participants, low-, mid- and high-cost alike, became property managers with an average of almost 40 percent of REO costs allocated to property maintenance (net of reimbursements).
- Productivity followed the low-mid-high core cost relationship for the customer service and ancillary functions (the largest and third-largest FTE areas). This finding suggests that customer service and ancillary function core costs are affected more heavily by productivity than areas such as collections and foreclosure, where costs are driven by factors such as portfolio age and mix.

Another possible factor contributing to this theory is that the low- and mid-cost servicers had their most experienced management in the customer service and ancillary functions areas, coupled with the least experienced staff. Higher cost servicers had their most-experienced management and least-experienced staff in the collections and foreclosure area. They also had 45 percent of their total personnel dedicated to this area.

- Consistent with 1989, low-cost servicers experienced growth in their portfolios, while higher cost servicers experienced net decreases in portfolio size.

Is bigger always better?

Participants were arbitrarily divided by 1990 average portfolio size into "larger" (more than 200,000 loans), "mid-sized" (between 125,000 and 200,000 loans) and "smaller" (less than 125,000 loans) servicing portfolios. Overall core cost ranged from $106 to $117 when moving from larger to smaller portfolios, representing a linear pattern.

However, the core cost for each of the four functional groupings (customer service, investor services, collections and foreclosure and ancillary functions) was hardly linear, suggesting that economies of scale exist within some of these functional groupings but not others. For example, the larger servicers had higher per-loan collection and foreclosure costs than either the mid-sized or the smaller servicers. However, the reverse was true for ancillary functions, where the larger servicers had lower per-loan costs than the mid-sized or smaller servicers.

The 1990 results also indicated that mid-sized servicers experienced a per-loan cost advantage in investor services while experiencing a per-loan cost disadvantage in customer services. This supports our theory that growth is felt unevenly across the key functional areas.

The ultimate challenge: profitability

There appeared to be several key factors in determining profitability for this year's study participants. Net portfolio change proved a good predictor for overall servicing profitability. Participants who experienced portfolio growth in 1990 were able to earn more income per loan than those who experienced portfolio shrinkage. The participants with the lowest net-servicing-income figures experienced portfolio shrinkage—the portfolios shrunk from a drop of 2,000 to upwards of 23,000 loans. Conversely, the highest servicing income participants experienced portfolio growth ranging from 13,000 to 36,000 loans.

Net portfolio change proved a good predictor for overall servicing profitability.

Participants with high profit margins tended to have a larger number of loans originated in the previous two years (1989 and 1990). Consequently, these participants had a higher average principal balance outstanding than participants with portfolios dominated by older loans.

Gross servicing fees accounted for 84 percent of total revenues, which gave a profitability edge to those participants with higher average principal balances outstanding. Ancillary income followed gross servicing fees, accounting for 10 percent of total revenues. Of the ancillary income accounted for in the 1990 study, 67 percent came from late charges collected, up 10 percent from 1989. This corresponded to the overall increase in delinquency rates (from 4.32 percent to 4.68 percent).

The study basics

Participants provided data in two forms. On a preformatted diskette, key cost accounting, productivity, operating, some balance sheet and profitability information was provided. Submitted in February, this data underwent several iterations of stringent review and validation, including preliminary graphical interpretation among participants. Nearly 3,000 cost, productivity, performance and profitability relationships were examined before selecting key results for presentation.

In written form, participants responded to profile, or qualitative, inquiries concerning servicing initiatives and projects, productivity and quality measures employed, capital and equipment investments, incentive programs and so forth. These profile results were summarized in table and matrix formats by participant and by functional area to provide a reference between the cost results and qualitative approach of the individual participants. For example, the data-processing cost results are followed by a complete matrix of data-processing systems, peripherals and the like, by participant.

Results of the data and profile analyses were provided to participants in mid-April. Participants also received an analysis depicting themselves against the average of each functional area in cost, salary, productivity and turnover. Specific functional areas were highlighted to signify how cost reduction in a given area would contribute to overall core-cost reduction. In addition, nearly all participants were visited during the data-collection or validation phases of the study to provide both participants and validators a better understanding of each participant's unique set of circumstances. Senior executives of participating firms met in early May to further analyze the results and to discuss how current trends are affecting their 1991 costs.

As the story goes, crossing the Rubicon was not the end of the line for Julius Caesar. History has it that he did well for a number of years after his crossing. The same is likely to be true for the mortgage servicing industry. While the $100 servicing-core-cost threshold has been crossed this year, 1990 remained a positioning year for the MSPS participants. Certainly, many are poised for lower servicing costs during 1991—hopefully they will slip back across the critical line. **MB**

Linda C. Simmons is a principal in KPMG Peat Marwick's Washington, D.C. office, and Michele M. Long is a senior manager in the Washington, D.C. office. Both Dr. Simmons and Ms. Long are active participants in the firm's national mortgage banking practice.

LENDING ASSISTANCE

In recent years, Fannie Mae and Freddie Mac have begun purchasing mortgages created under local affordable housing programs; making community reinvestment a more viable opportunity for lenders.

Tom R. Dalton

Both secondary mortgage market giants, Freddie Mac and Fannie Mae, have established "targeted" affordable housing departments during the past few years. Each agency is quick to point out that these developments are part of their long-standing efforts in this regard, citing statistics and numerous earlier examples of their affordable housing activities. Each also will point to the average size of the mortgages they purchase as further evidence of their affordable housing efforts.

All these statistics, examples and average loan balances are true. Each organization has and is making a variety of efforts in this area. These efforts include cash equity investments, special mortgage underwriting guidelines, mortgage counseling programs and direct grants. The cumulative numbers are certainly substantial. Particularly, when you consider that the central mission of each organization is to help provide liquidity to the national mortgage market through linkage with the capital markets. In providing this linkage, each agency helps reduce the cost of mortgage credit. By reducing the overall cost of mortgage credit, Fannie Mae and Freddie Mac make housing more affordable for all Americans.

However, as Congress formulated legislation to address the savings and loan industry crisis, it also made changes to the charters of Freddie Mac and Fannie Mae. Hidden somewhat behind the publicity on Freddie Mac's new board of directors, behind the coverage devoted to which department of the government will regulate the secondary market giants and behind the headline-grabbing revisions to the regulation of the thrift industry, was the first direct mention of a responsibility to foster affordable housing on the part of the two agencies. The existing language in the charter of each organization now reads "...provide ongoing assistance to the secondary market for home mortgages (including mortgages securing housing for low- and moderate-income families involving a reasonable economic return to the Corporation)..." Fannie Mae already had created its Office of Low- and Moderate-Income Housing in September 1987, prior to passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) and Freddie Mac created its Affordable Housing Initiatives Department approximately one year after passage of the legislation.

When asked what prompted Fannie Mae to create a separate department for affordable housing, Fannie Mae Senior Vice President of Low- and Moderate-Income Housing Initiatives Marty Levine said, "Fannie Mae has always felt [it] had a responsibility to support affordable housing." While acknowledging the legislation had some impact, Levine says, "Fannie Mae's creation of the department and increased efforts in this area in the 1980s is more a function of the improved profitability of the organization and the likelihood of that profitability continuing for the foreseeable future. As we became more profitable and could see that trend continuing, we could expand our targeted programs and outreach efforts."

Carl Riedy, Freddie Mac vice president for affordable housing initiatives, says the rationale for creating his department was fourfold.

- The growing impact of the secondary market on all facets of the mortgage industry.
- Increased Community Reinvestment Act (CRA) pressures on the agency's customers from regulators and recent legislation increased the requests for assistance in this area.
- Heightened awareness of housing affordability issues in general.
- Corporate charter changes generated by FIRREA.

Whatever the genesis, each organization now has a separate affordable housing initiatives department within its corporate structure. The affordable housing department is a part of the marketing divisions inside each agency. The companies also have made affordable housing initiatives a specific marketing responsibility for their regional sales forces.

NATIONAL AFFORDABLE HOUSING PROGRAMS MUST AVOID FORCING SUCCESSFUL LOCAL INITIATIVES (SQUARE PEGS) INTO TIGHTLY STRUCTURED NATIONAL PROGRAMS (ROUND HOLES).

Overview of initiatives

Fannie Mae's low- and moderate-income housing initiatives can be divided into four broad categories: public finance, community lending, low-income rental housing equity investments and other special initiatives.

Public finance initiatives involve working with state and local housing finance agencies (HFAs) to reduce the cost of mortgages that are financed with mortgage revenue bonds. By selling bonds directly to Fannie Mae, HFAs can reduce their borrowing costs; making more funds available and at lower rates than would normally be possible. In this area, Fannie Mae is also providing credit enhancement for tax-exempt mortgage revenue bonds. This credit enhancement using Fannie Mae mortgage-backed securities makes the bonds eligible for "triple-A" ratings thus reducing the HFA's financing costs and simultaneously eliminating the need for pool insurance. These same techniques can be used for both home and multifamily bond issues.

Fannie Mae's community lending initiatives involve specially designed community lending programs fashioned in partnership with lenders, mortgage insurers, public agencies and nonprofit organizations. Typically these programs involve low down payments, reduced closing costs and more flexible qualifying ratios for borrowers. One significant feature is the "3/2 Option," where homebuyers meet the minimum 5 percent down payment requirement with 3 percent of the funds coming from their personal resources and up to 2 percent coming from a gift from a family member or a grant or unsecured loan from a nonprofit organization or public entity.

The low-income rental housing equity investments are corporate financial commitments to invest cash equity in low-income rental housing in exchange for federal tax credits. In order for projects to qualify for these tax credits, at least 20 percent of the units in each project must be set aside for low-income tenants for a period of not less than 15 years. Since 1987, Fannie Mae has committed $162.8 million to low-income tax-credit investments. (See Chart 1.)

Other special affordability initiatives at Fannie Mae include efforts such as demonstration projects to create models for the development of employer-assisted housing in high-cost markets; a special arrangement with the Mortgage Bankers Association of America (MBA) to provide debt or equity financing for rental housing projects in six different communities; and the annual Fannie Mae Foundation Awards for innovative community-development efforts.

Freddie Mac's initiatives are most easily differentiated by property type into separate homeownership and rental property strategies.

The homeownership strategy can be segregated further into targeted lender initiatives and public partnerships. In a sense, this division could be characterized as existing- and new-customer initiatives. The strategy is to work with targeted lenders (existing customers) to design and develop tailored programs that meet the needs of their community and marketplace. At the same time, Freddie Mac is working with public partnerships (new customers) such as state/local housing finance agencies and nonprofit organizations to help meet their needs in providing and maintaining affordable housing units.

Many of the tools and/or techniques used to further these strategies are similar with both groups. They include low down payments (typically 5 percent), reduced closing costs and flexible qualification requirements and alternative verification procedures for credit histories. A significant feature that has increasingly appeared in Freddie Mac programs is mandatory borrower counseling prior to and following loan closing. Pursuant to this, two major counseling seminars were held in mid-June sponsored in conjunction with the MBA and the National Low Income Housing Coalition (NLIHC).

Freddie Mac's rental property strategy also has several components. The first of these is its low-income, rental, tax-credit equity investment activities. During the past three years, Freddie Mac has committed $57.646 million to these investments.

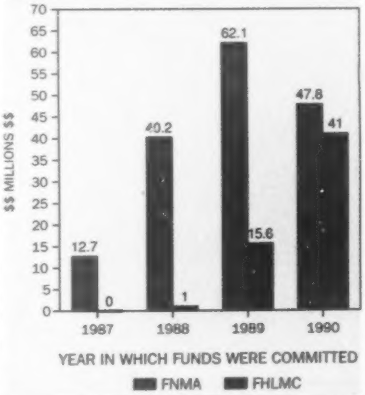
The second component of Freddie Mac's rental strategy was initiated earlier this year with the announcement of a two-year commitment in partnership with the National Community Development Initiative (NCDI). NCDI will operate through the country's two leading community development support organizations—the Local Initiatives Managed Assets Corporation (LIMAC) and The Enterprise Foundation. Under the terms of the agreement, LIMAC will purchase low-income rental housing mortgages from local lenders and sell those multifamily mortgages to Freddie Mac. Under this program, LIMAC will provide credit support for the mortgages as well as local community lending expertise. Freddie Mac's Riedy says, "I am hopeful that this agreement will act as a framework for similar ventures with other nonprofit organizations and foundations."

The final component of Freddie Mac's rental strategy is currently

CHART 1

Tax Credit Equity Investment

FNMA vs FHLMC



THERE IS SO MUCH THAT REMAINS TO BE DONE IN THE AFFORDABLE HOUSING AREA, FANNIE MAE AND FREDDIE MAC NEED NOT COMPETE FOR MARKET SHARE IN THIS BUSINESS.

under development with an announcement anticipated by early 1992. The objective is to design a program to help preserve the existing inventory of low-income housing stock in this country. During the past two decades, a considerable supply of low-income housing stock has been generated through the HUD 236 program (Mortgage Insurance and Interest Reduction Payments for Rental Projects) and Section 8 housing assistance payments programs. Under these programs, projects were required to maintain units as low-income housing or had rents subsidized by Section 8 assistance contracts. During the next few years, the rental assistance contracts and low-income unit restrictions on these projects will be expiring. There is significant risk that with the expiration of these agreements, a large percentage of these units will become market-rate rentals. Riedy envisions Freddie Mac developing a program to help keep these units for low-income rental housing.

Similarities

Now that we have discussed the nuances that distinguish the two agencies approaches, what things are the two agencies doing alike? Each organization is:

- investing equity in low-income, rental housing, tax credits.
- working with lenders, mortgage insurers, housing finance agencies, public agencies and nonprofit organizations to develop programs and initiatives defined by local markets and needs.
- engaged in joint initiatives with organizations such as the LIMAC, the Enterprise Foundation and the MBA.
- making affordable housing initiatives a responsibility of its regional marketing staff.
- tracking separate risk elements on all affordable housing purchases in order to develop national databases.

There are also a number of similarities in the underwriting terms and flexibilities that have been used in home mortgage commitments.

- Generally, 5 percent down payment requirements are allowed. Fannie Mae and Freddie Mac have allowed 2 percent of the 5 percent down payment to be in the form of a loan from a family member or grant from a nonprofit organization. Freddie Mac has also allowed in at least one commitment that an additional 1 percent of the 5 percent down payment could be in the form of sweat equity.
- Qualification ratios are typically negotiated at 33 percent and 38 percent.
- Borrower liquidity reserves are often waived.
- Borrowers without substantial credit histories can generally establish verifications through nontraditional means, including utility companies or previous landlords.
- New homeowner counseling is often encouraged or required during pre- and post-closing.
- Gifts from family members can be used to pay closing costs.

Differences

Interestingly, even within these similarities there are differences. For instance, both Fannie Mae and Freddie Mac have invested in low-income rental-housing tax credits. Freddie Mac's investment began later than Fannie Mae's but there are differences beyond just timing. One hundred percent of Freddie Mac's tax credit investments have been in funds where they are one of several investors and the fund always involves multiple properties. By comparison, approximately 40 percent of Fannie Mae's tax credit investments have involved single assets, where Fannie Mae was the sole limited partner. These differences may be explained, in part, to timing. Fannie Mae's Levine explains, "When we made our initial tax-credit commitments, the tax-credit marketplace wasn't as developed as it is today. As a result, the investments that were available early on were nearly all single asset and sole limited partnerships." However, each organization does have a policy prohibiting its involvement in debt purchases when it is also an equity investor. Curiously, there has been at least one transaction where Freddie Mac and Fannie Mae were limited partners in the same transaction.

Other differences include Fannie Mae's significant efforts in purchasing and providing credit enhancement for mortgage revenue bonds, an area with which Freddie Mac has yet to become involved. Fannie Mae has assembled a home office and regional staff in the affordable housing area of approximately 40 people. Freddie Mac currently has seven staff members devoted to these efforts, all in the corporate headquarters. "We have made the conscious decision to process and purchase affordable housing products through our existing business structures and systems," says Riedy of Freddie Mac. "We are currently training our existing regional staff, and feel confident we can accomplish our objectives in this manner."

Helping the locals

This article has devoted only limited attention to transaction volumes. This was intended for a number of reasons. First, as indicated earlier, there are timing issues that would skew calendar-year and total-production comparisons. Second, the strategies used by the two organizations make direct comparisons difficult.

The primary focus of this article has been to show similar and different approaches the two secondary market agencies are taking in affordable housing. In terms of similarities, there are two statements with which both organizations will agree. First, there is so much that remains to be done in the affordable housing area, Fannie Mae and Freddie Mac need not compete for market share in this business. Second, to be successful, national affordable housing programs must be flexible, tap the expertise of local programs, and avoid forcing successful local initiatives (square pegs) into tightly structured national programs (round holes). **MB**

Tom Dalton is managing director of T.R. Dalton and Associates, Reston, Virginia. He has 20 years experience in the mortgage industry, including more than six years with Freddie Mac in home and multifamily programs.

ECONOMIC TRENDS

There is a widespread perception that housing affordability is a significant stumbling block to homeownership in the U.S., but there have been few studies that have documented the extent of the problem. For this reason, a new Census Bureau study, *Who Can Afford to Buy a House?*, by Census Bureau economists Peter J. Fronczek and Howard A. Savage, is an important contribution to the literature.

In it, the authors use detailed data on assets, debt and income in the late 1980s to determine whether families or individuals could qualify for the purchase of a home in their region using conventional or FHA financing. The results are enlightening.

Table 1 shows the factors that would prevent families and individuals from qualifying for the purchase of a median-priced home in their region and a modestly priced home using conventional fixed-rate financing. The median-priced home is the price at which half the homes in the region cost more and half cost less. A modestly priced home is defined as a home priced so that three-fourths of the homes in the region cost more and one-fourth cost less.

TABLE 1

Factors Preventing the Purchase of a Home
[Percent of Total Who Cannot Afford to Purchase Using Conventional Fixed-Rate Financing]

		Home Price	
		Median Priced Home	**Modestly Priced Home**
	Owners (Number in Millions Who Cannot Afford)	22.6	15.6
Percent Distribution by Reason Cannot Afford:	Cannot Afford Down Payment	48.1%	33.9%
	Cannot Afford Monthly Payments . . .	5.9%	11.1%
	Debt Level Too High . . .	7.6%	19.1%
	Combination of Reasons	38.5%	36.0%
	Renters (Number in Millions Who Cannot Afford)	34.3	32.2
Percent Distribution by Reason Cannot Afford:	Cannot Afford Down Payment	8.0%	5.5%
	Cannot Afford Monthly Payments . . .	6.0%	12.4%
	Debt Level Too High	4.3%	11.1%
	Combination of Reasons	81.7%	71.0%

Source: U.S. Bureau of the Census

TABLE 2

Comparison of Affordability Using Conventional or FHA Financing
[Millions]

	Home Price	
	Median Priced Home	**Modestly Priced Home**
Total Who Cannot Afford:		
Using Conventional Financing	56.9	47.8
Using FHA Financing	54.9	44.9
Differences Between Conventional and FHA	2.0	2.9

Source: U.S. Bureau of the Census

Of current owners, about 22.5 million could not qualify for the median-priced home, and of these, around 15.5 million could not qualify for the modestly priced home. These figures partly reflect the fact that many current owners live in homes priced below the modestly priced home, but the numbers also reflect changes in the financial circumstances of current owners since the time they bought their home. For example, they may have been working when they purchased, but now they are retired—a change in life circumstances that may lead to disqualification for insufficient current income.

In the case of the median-priced home, the down payment hurdle is the most significant reason current owners could not qualify—accounting for more than 48 percent of those who could not qualify. This is an impressive share considering that equity in their current home would be available for the down payment, and still would not be enough to get them into the median-priced home. Disqualification on multiple factors was a close second, accounting for 38.5 percent. The numbers are similar for a modestly priced home, with the down payment hurdle accounting for nearly 34 percent of those who could not qualify, and multiple factors accounting for another one-third.

In the case of renters, more than 34 million could not qualify for the median-priced home, while more than 32 million could not afford the modestly priced home. In both cases, the overwhelming majority of renters who could not qualify could not do so for a combination of reasons. In short, it was not a single affordability constraint that would prevent most renters from qualifying, but several affordability constraints involving some combination of insufficient funds for down payments, insufficient income and/or too much debt.

In the late 1980s, though, the FHA program helped mitigate affordability problems significantly. Table 2 shows how many more families and individuals could qualify for home purchases using FHA financing compared to conventional financing. In the case of median-priced homes, more than 2 million more families and unrelated individuals could qualify; in the case of modestly priced homes, the number jumps to nearly 3 million.

The implication is clear. The FHA program provided vital opportunities for homeownership in the late 1980s. Unfortunately, the reforms to the FHA program so far in the 1990s unquestionably reduce opportunities for homeownership. When the Census Bureau updates this study several years from now, and reports affordability using current FHA financing requirements, it will be distressing to see just how significant the reductions in opportunities have been.

Thomas M. Holloway
Senior Economist

VITAL STATISTICS

KEY ECONOMIC INDICATORS AND INTEREST RATES

			CHANGES IN CONSUMER PRICES FROM YEAR AGO LEVELS (%)		MORTGAGE INTEREST RATES (%)		
	CHANGES IN PAYROLL EMPLOYMENT (THOUSANDS)	UNEMPLOYMENT RATE (%)	ALL ITEMS	ALL ITEMS LESS FOOD AND ENERGY	SECONDARY MARKET YIELD ON FHA NEW HOME MORTGAGES[1]	FHLMC	
						ARMs	FRMs
JUNE-90	131	5.3	4.7	4.9	10.21	8.49	10.16
JUL-90	−166	5.5	4.8	5.0	10.15	8.43	10.04
AUG-90	−109	5.6	5.6	5.5	10.20	8.35	10.10
SEP-90	−47	5.7	6.2	5.5	10.26	8.28	10.18
OCT-90	−131	5.7	6.3	5.3	10.24	8.21	10.18
NOV-90	−221	5.9	6.3	5.3	10.02	8.10	10.01
DEC-90	−140	6.1	6.1	5.2	9.74	7.93	9.67
JAN-91	−203	6.2	5.7	5.6	9.62	7.74	9.64
FEB-91	−258	6.5	5.3	5.6	9.58	7.65	9.37
MAR-91	−258	6.8	4.9	5.2	9.59	7.47	9.50
APR-91	−166	6.6	4.9	5.1	9.61	7.38	9.49
MAY-91	119	6.9	5.0	5.1	9.62	7.22	9.47
JUNE-91	−50	7.0	NA	NA	NA	7.24	9.62

RATES ON SELECTED SECURITIES (%)

	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT				A-Rated Utility
			6-Month	1-Year	3-Year	10-Year	
JUN-90	8.29	8.14	7.63	8.10	8.40	8.48	9.85
JUL-90	8.15	7.99	7.52	7.94	8.26	8.47	9.96
AUG-90	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP-90	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT-90	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV-90	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC-90	7.31	7.80	6.70	7.05	7.47	8.08	9.95
JAN-91	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB-91	6.25	6.49	5.93	6.27	7.08	7.85	9.54
MAR-91	6.12	6.41	5.92	6.40	7.35	8.11	9.58
APR-91	5.91	6.07	5.71	6.24	7.23	8.04	9.46
MAY-91	5.78	5.92	5.61	6.13	7.12	8.07	9.45
JUNE-91	5.90	6.11	5.75	6.36	7.39	8.28	9.53

CURRENT SECONDARY MARKET YIELDS (%)

SPREADS
(Basis Points)

	GNMA[2]	FNMA[2]	FHLMC[2]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
JUN-90	9.73	9.73	9.72	125	125	124
JUL-90	9.66	9.66	9.66	119	119	119
AUG-90	9.80	9.75	9.75	105	100	100
SEP-90	9.86	9.79	9.73	97	90	84
OCT-90	9.84	9.80	9.69	112	108	97
NOV-90	9.63	9.66	9.54	124	127	115
DEC-90	9.22	9.27	9.16	114	119	108
JAN-91	9.17	9.24	9.12	108	115	103
FEB-91	8.81	8.86	8.77	96	101	92
MAR-91	9.00	9.03	8.93	89	92	82
APR-91	8.95	8.98	8.88	91	94	84
MAY-91	8.94	8.95	8.86	87	88	79
JUNE-91	9.15	9.17	9.06	87	89	78

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit
(Millions of Dollars)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies
JUN-90	38,428	9,714	13,209	15,063	29	2,778	209	989	682	182	16,411	105	666	12,303	3,097
JUL-90	35,524	9,627	12,020	13,461	30	2,082	165	871	696	209	16,222	98	476	12,525	2,984
AUG-90	35,777	10,359	12,940	12,032	34	2,582	106	950	1,243	92	18,967	107	650	14,783	2,994
SEP-90	34,210	9,825	10,617	13,347	36	2,008	178	855	608	112	20,231	102	577	16,100	3,343
OCT-90	35,229	12,128	11,317	11,395	37	1,719	41	843	606	28	13,941	99	551	10,049	3,041
NOV-90	32,595	13,104	8,750	10,361	43	2,074	211	669	887	122	16,352	92	580	12,321	3,288
DEC-90	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUN-90	1,187	931	256	1,123	850	273	114	241	532	300	124	229	425	345
JUL-90	1,155	907	248	1,086	839	247	115	226	492	322	115	228	421	322
AUG-90	1,131	865	266	1,055	817	238	122	240	434	335	114	221	405	315
SEP-90	1,106	893	213	989	778	211	104	239	445	318	111	218	385	275
OCT-90	1,026	861	165	925	747	178	144	230	392	260	114	194	360	257
NOV-90	1,130	823	307	916	710	206	147	232	483	268	108	194	366	248
DEC-90	971	768	203	854	689	165	110	233	395	233	99	181	338	236
JAN-91	847	677	170	802	651	151	86	167	361	233	96	188	306	212
FEB-91	992	825	167	876	739	137	91	301	384	216	99	205	353	219
MAR-91	907	770	137	892	734	158	104	226	390	187	96	204	340	252
APR-91	981	840	141	913	787	126	96	238	397	250	102	210	361	240
MAY-91	982	864	118	979	798	181	113	217	367	285	106	224	383	266
JUNE-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOME SALES

(Units and Prices in Thousands)

	EXISTING HOMES		NEW HOMES		
	Sold (SAAR)	Median Sales Price (Dollars)	Sold (SAAR)	Median Sales Price (Dollars)	Months Supply At Current Sales Rate
JUN-90	3,370	98.9	549	125.0	7.9
JUL-90	3,320	98.1	541	118.7	8.0
AUG-90	3,410	97.2	525	118.4	8.1
SEP-90	3,160	94.4	504	113.0	8.4
OCT-90	3,070	92.9	465	120.0	8.7
NOV-90	3,150	92.0	480	118.9	8.2
DEC-90	3,130	91.7	464	127.0	8.4
JAN-91	2,900	95.6	414	117.9	9.3
FEB-91	3,160	94.0	488	119.9	8.0
MAR-91	3,220	98.2	491	122.9	7.5
APR-91	3,310	100.3	490	120.0	7.5
MAY-91	3,510	99.7	474	121.9	7.8
JUNE-91	NA	NA	NA	NA	NA

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

	Total[5]	1-Unit	2+ Units	Nonresidential
JUN-90	307.5	99.4	17.3	108.3
JUL-90	309.1	97.3	17.1	112.5
AUG-90	301.3	95.3	17.4	106.6
SEP-90	296.7	92.8	16.9	105.6
OCT-90	291.3	90.9	16.7	102.6
NOV-90	285.2	88.0	16.1	100.0
DEC-90	280.6	85.7	16.9	98.5
JAN-91	274.1	81.8	16.3	95.0
FEB-91	270.9	78.6	15.6	96.1
MAR-91	264.5	76.3	15.4	93.3
APR-91	268.4	76.6	14.4	97.6
MAY-91	263.9	80.1	14.1	90.2
JUNE-91	NA	NA	NA	NA

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Securities for 0- to 30-day delivery.

[3] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[4] Savings & Loans and Mutual Savings Banks.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

MORTGAGE BANKING

SEPTEMBER 1991

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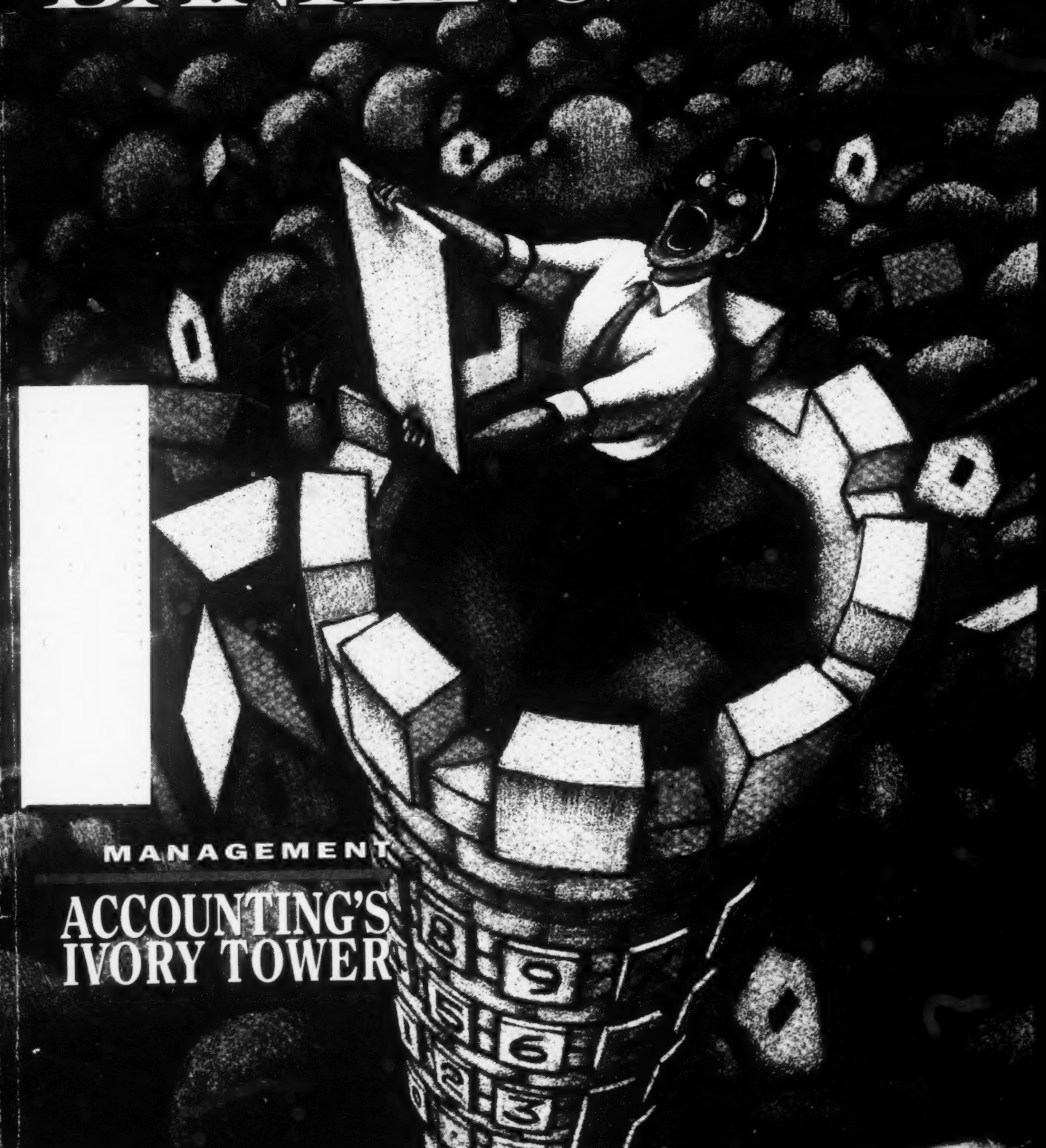

MANAGEMENT

ACCOUNTING'S IVORY TOWER

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PORTFOLIO

Accounting Lingo

Accounting exerts its totalitarian hold on business practices in many fundamental ways. Mortgage banking is no different. The behavior that accounting rules spawn appears extremely convoluted, as businessmen bend their strategic plans around the strange bumps in the terrain that accounting dictums produce.

But the rules are important ones at least to accountants and their most senior brethren—the policymakers at the Financial Accounting Standards Board (FASB). FASB policymakers are seeking to forge a utopian world where what's on the balance sheet is meaningful to all who read it and where assets are accounted for in a way that truly reflects the value that lies therein. But what often arises is a kind of looking-glass world where things are done in very peculiar ways solely for accounting purposes.

This issue is devoted to corporate management issues, and accounting is certainly one of those issues that top management must wrestle with. One of our authors provides an account of the many micropieces of the industry that are under examination currently by various FASB task forces or emerging-issues analysts or the other rocket scientists of modern financial accounting.

This issue also covers recent findings from important work being done by KPMG Peat Marwick in Washington, D.C. to delve into the mysteries of portfolio and operational traits that lead to higher and lower servicing costs. These findings are breaking new ground that could lead mortgage banking's senior managers to find the path to maximizing servicing income.

Finally, the issue also profiles the evolution of effective new hedging tools to cover one of the biggest risks affecting buyers of servicing—prepayments. And an annual report card from the Mortgage Bankers Association of America's economics department on how servicers did in controlling costs and generating income rounds out an issue filled with data to help the industry's managers and their companies prosper, in spite of the accountants.

EDITOR'S NOTE: In our August issue, in the article titled "The Factors Driving Wholesale," Phillip Bracken's company prior to its recent purchase should have been identified as America's Mortgage Company. Also, in the July issue, a chart on page 42 that accompanied the article "Apartment Lending After the Boom" was labeled incorrectly. The top line (solid) represents total housing units, the middle line shows single-family units and the bottom line depicts multi-family units.

Janet Reilley Hewitt
Editor in Chief

COMING IN OCTOBER

Our annual convention issue tackles the big issues surrounding housing's future frontiers. Products, housing policy, new geographic market frontiers and MBS breakthroughs on the horizon are among the topics we will explore.

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Clocking the Industry's Performance

The mortgage banking industry has been posting better performances lately, as companies pull out all the stops to control costs. The business is getting maximum mileage out of productivity gains—particularly in servicing, MBA's latest Cost Study shows.

BEAUWYN
7 JEWELS
1/5

Robert M. Rosenblatt

AFTER TWO VERY difficult years, profitability in the mortgage banking industry began to recover in 1989, according to The Mortgage Bankers Association of America's (MBA) 1989 Cost Study, a survey of 145 firms in the mortgage banking industry. The firms surveyed included companies of all sizes, ownership structure and geographic location, whose average volume serviced was $2.4 billion and average origination volume produced was approximately $350 million.

For this report of 1989 data, the individual company data were derived for the first time from the *Mortgage Bankers Financial Reporting Form*. Quarterly submissions of this form are now required from all mortgage banking companies that are approved GNMA, Fannie Mae and/or Freddie Mac seller/servicers. The form contains sections that provide a detailed allocation of annual income and expenses across function (i.e., loan production, warehousing, marketing and servicing).

Overview

The average profit margin (excluding sales of servicing) of the 145 companies that provided detailed statistics

PHOTOGRAPHY BY ED CASTLE

on income and expenses by mortgage banking function was 5.5 percent in 1989, up from averages of 0.7 percent in 1987 and 1.7 percent in 1988 (see Table 1). While an improvement, the average profit margin in 1989 remained well below the 1986 level of 19.6 percent and below the 1984 to 1988 average of 11.3 percent.

A somewhat less-hostile lending environment for mortgage bankers combined with successful efforts to boost productivity and reduce costs in both loan production and servicing were the primary forces behind the improvement in profitability in 1989. While the total loan-origination market did not expand in 1989—remaining at about $480 billion—the mounting troubles of the thrift industry and a declining consumer preference for adjustable-rate mortgages enabled the mortgage banking industry to increase its market share by 3.5 percentage points to 34.5 percent. This increase in market share resulted in a 12 percent gain in origination volume by the mortgage banking industry, from an estimated $148 billion in 1988 to an estimated $161 billion in 1989.

In a further positive development, serious mortgage delinquencies and foreclosures continued to decline in 1989, reducing expenses for provision for loan losses and expenses to service foreclosures and real-estate owned (REO). Higher problem-loan expenses during the previous two years was a major contributing factor to the overall decline in profitability.

The increase in market share and the decline in problem loan expenses complemented ongoing efforts within the industry to increase productivity and reduce costs. These efforts yielded a sizable payoff in 1989. Loans closed in-house, per origination employee rose to 35 from 26 in 1988, reducing average retail origination expenses per loan to 266 basis points from 282 basis points. Similarly, loans serviced per loan-administration employee rose from 616 in 1988 to 696 in 1989, contributing to a decline in direct servicing expenses per loan from 19 basis points to 16 basis points.

Servicing takes off

As mortgage companies strive to adapt to today's changing business environment, mortgage servicing appears to be one of the bright spots. At the average firm, net servicing income in 1989 was $2.7 million, edging out warehousing as the most profitable aspect of the mortgage banking operation, as shown in Table 1. Although servicing profitability was still low by historical standards, it appears that the recent emphasis on containing costs and improving productivity was paying off. The profit margin for servicing, which rose for the second consecutive year, was 26.4 percent in 1989. Moreover, net servicing income as a percent of the dollar volume serviced increased 7 percent in 1989 to 11 basis points (see Table 2).

A positive consequence of management's more intensive efforts to maximize net income from the servicing portfolio was a 24 percent rise in per-loan, net-servicing income (see Table 3). In 1989, net servicing income was $61 per loan compared to $49 per loan in 1988. One of the keys to this improvement was the stability of direct expenses. In 1989, direct expenses rose only 1 percent to $89 per loan. This stability reflected another increase in servicing productivity.

The number of loans serviced per servicing employee rose by 80 loans, or 13 percent, to 696 in 1989, from 616 the prior year. Another contributor to the improvement in net income was the sharp reduction in provisions for loan losses. With delinquency and foreclosure problems abating slightly in 1989, expenses allocated to provision for loan losses fell by 38 percent to $17 per loan.

Partially offsetting these developments was a sharp increase in the amortized cost of purchased servicing (ACPS). Firms in this survey continued to increase their purchases of servicing rights in 1989. As a result, this cost component jumped 40 percent to $66 per loan. In addition, while gross servicing income rose 10 percent in per-loan terms, it fell from 45 basis points to 42 basis points when expressed as a percent of the dollar volume serviced.

Servicing income

Total servicing income per loan, as noted above, rose 10 percent in 1989, to $233 from $211 in 1988, as shown in Table 3. An examination of the various components of income shows that servicing fee income—the bread and butter of the servicing operation—rose 8 percent in 1989 to $199 per loan. This increase is due solely to the 17 percent rise in the average loan size serviced, which went from $46,863 in 1988 to $54,786 in 1989. Servicing fees as a percent of the dollar volume serviced fell 3 basis points to 36 basis points. Other loan administration income increased 21 percent to $36 per loan. Losses on sales of REO were up in percentage terms in 1989, but still remained near the $2 per-loan cost recorded the previous year.

Another common source of income for mortgage companies today, gains from sales of servicing rights, were lower in 1989 for the average firm in the survey. This was in contrast to the real estate finance industry as a whole, where an estimated $155 billion in servicing was transferred in 1989, about the same as in 1988. Given the decline in servicing transfers (based on number of loans transferred) at the average firm in the survey, gains from sales of servicing as a percent of the dollar volume serviced were only 8 basis points in 1989 compared to 14 basis points in 1988. But even with this decline, total servicing income for survey respondents was greatly enhanced by gains related to the sale of servicing rights. On a per-loan basis, revenues from sales of servicing were $44 in 1989. When this additional source of income was taken into consideration, servicing income jumped to $277 per loan. Moreover, when including gains from the sale of servicing, the profit margin increased to 38 percent, which was very close to the average profit margin during the good years of the early to mid-1980s.

Servicing expenses

Total servicing expenses were $171 per loan in 1989, 6 percent higher than the $162 figure of the prior year. However, as a percent of the dollar volume serviced, total expenses were only 31 basis points, 10 percent less than in 1988. Moreover, direct expenses were nearly unchanged, and the expense category of provision for loan loss registered marked improvement. Essentially all of the increase in costs was concentrated in the amortized cost of purchased servicing.

Direct expenses, the largest component of costs, were $89 per loan in 1989, 1 percent higher than they were in 1988. But even with this per-loan increase, direct expenses as a percent of the dollar volume serviced fell 3 basis points to 16 basis points in 1989.

In recent years, mortgage servicers have begun to effectively use new technology to streamline their basic operations, with the result being higher productivity and lower costs. In 1989, costs declined in a number of key direct-expense categories, including personnel, occupancy and electronic data processing (EDP). All of the increase in direct expenses was in the "other direct expenses" category, and most of this was concentrated in the catch-all, "all other direct expense" subcategory used for miscellaneous expenses.

Personnel costs, which accounted for about 40 percent of direct expenses, declined for the second year in a row (see Table 4). As a percent of the dollar volume serviced, personnel costs fell from 8 basis points in 1988 to 6 basis points in 1989, and on a per-loan basis, fell 6 percent to $35. This drop in personnel costs reflected the increase in productivity. In fact, productivity was at its highest level of the decade. Specifically, in 1989, the number of loans serviced per servicing employee rose by 13 percent, or 80 loans, to 696. In addition to the increase in productivity, other changes likely had an effect on personnel costs in 1989. For instance, evidence indicates that servicing employment fell in 1989. Salaries, however, jumped 29 percent to $24,541. Most likely, the people that were retained were the more-experienced and higher salaried employees.

Occupancy expenses fell for the first time in four years. On a per-loan basis, occupancy expenses were $5 in 1989, 9 percent less than the prior year. Moreover, as a percent of the dollar volume serviced, occupancy expenses fell below 1 basis point in 1989.

TABLE 1

Income and Expenses per Firm (In Thousands)
Average Firm 1987-1989

	1989	1988	1987
Gross Income	$23,305	$24,187	$26,066
Loan Production	4,693	4,529	5,712
Warehousing	7,772	8,104	8,979
Marketing*	594	345	1,770
Servicing	10,246	11,209	9,605
Servicing, Incl Sale of Servicing	12,196	14,759	N/A
Expenses	$22,029	$23,767	$25,880
Loan Production	9,226	9,593	11,023
Warehousing	5,258	5,410	6,699
Marketing*	N/A	172	394
Servicing	7,545	8,592	7,764
Net Income, Total (Before Tax)	$1,276	$420	$186
Loan Production	-4,533	-5,064	-5,311
Warehousing	2,514	2,694	2,280
Marketing*	594	173	1,376
Servicing	2,701	2,617	1,841
Servicing, Incl Sale of Servicing	4,651	6,167	N/A
Memorandum Items:			
Profit Margin (1)	5.5%	1.7%	0.7%
Profit Margin, Incl Sale of Servicing (1)	12.6%	14.3%	N/A
Number of Firms Reporting	145	114	124

* In 1989 marketing data is provided in net income terms only.

[1] The overall profit margin calculations for 1989 are estimates because gross marketing income was not available.

TABLE 2

Trends in Servicing Income and Costs
Average Firm 1980-1989

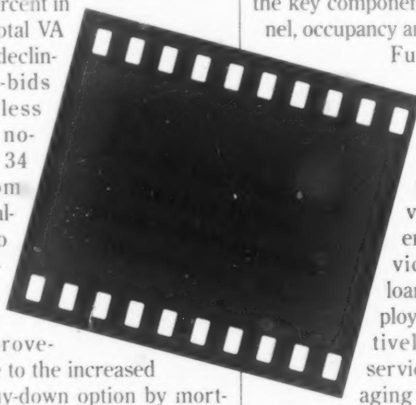
	1989	1988	1987	1986	1985	1984	1983	1982	1981	1980
Percent of Dollar Vol. Serviced:										
Gross Income	0.42	0.48	0.43	0.44	0.46	0.47	0.44	0.46	0.45	0.46
Expenses	0.31	0.37	0.35	0.33	0.25	0.24	0.25	0.23	0.21	0.21
Net Income	0.11	0.11	0.08	0.11	0.20	0.23	0.19	0.23	0.24	0.25
Selected Expenses Per Loan:										
Provision for Loan Losses	$17.05	$27.39	$13.41	$12.19	$4.98	$4.20	$2.43	$-0.09	$0.86	$0.48
Net Gain (Loss) on Sale of REO	$-2.25	$-1.96	$-5.08	$-10.49	$-6.77	$-4.99	$-1.75	$-1.11	$-0.92	$-0.16
Amortized Cost of Purchased Servicing	$65.85	$47.14	$47.09	$39.46	$23.68	$20.15	$17.88	$15.03	$10.58	$10.25
Expenses to Service Foreclosures & REO	$7.91	$8.07	$15.14	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Electronic data processing costs fell for the second consecutive year. In 1989, EDP expenses declined 10 percent to $8 per loan. However, EDP costs per servicing employee rose 1 percent to $5,418. While the changes were moving in opposite directions, these numbers were not inconsistent. The increased use of computer technology in the work place was one of the main reasons for the increase in productivity. In addition, EDP costs fell as a percent of the dollar volume serviced.

The other-direct-expenses category, which includes a number of cost areas, rose 13 percent in 1989 to $40 per loan. As shown in Table 5, most of the increase was in the miscellaneous, all-other-direct-expense subcategory, which rose 16 percent to $27 per loan for the average firm. Two other components of this category, losses on MBS pools and non-EDP depreciation, also rose in 1989. Losses on mortgage-backed security (MBS) pools increased to $4 per loan in 1989 from $3 per loan in 1988, and non-EDP depreciation rose 26 percent to $2 per loan. Expenses to service foreclosures and REO remained at $8 per loan, the same as the previous year.

For the first time since the early 1980s, problem-loan expenses improved in 1989. As a percent of the dollar volume serviced, losses related to delinquency and foreclosure problems—which include provision for loan losses, expenses to service foreclosures and REO and losses on sales of REO—fell to 5 basis points in 1989 from 8 basis points in 1988. Moreover, stated in per-loan terms, problem loan expenses were only $27 in 1989, 27 percent lower than the $37 figure recorded in the prior year. Almost all of the improvement was in provision for loan losses, which fell to $17 per loan in 1989 from $27 per loan in 1988. As a result, provision for loan losses represented only 10 percent of total servicing expenses in 1989 compared to 17 percent the previous year. The other two costs associated with problem loans were about unchanged in 1989. Expenses to service foreclosures and REO remained at about $8 per loan, and losses from sales of REO remained at $2 per loan.

This decline in problem-loan expenses reflected industry-wide improvement in the delinquency and foreclosure situation. Based on data from the Mortgage Bankers Association of America's *National Delinquency Survey*, the percentage of loans 90 days or more past due fell from an average of 0.86 percent in 1988 to 0.79 percent in 1989. In addition, the percentage of loans in the foreclosure process at the end of 1989 was only 0.76 percent, 19 basis points less than it was at the end of 1988. More specifically, total VA foreclosures, which have proven to be very costly, declined 13 percent in the government's fiscal-year 1989, to a total of 41,456. Even more important was the decline in VA no-bids. During fiscal year 1989, the VA used the no-bid option in only 18 percent of its foreclosure decisions compared to 24 percent in 1988. With total VA foreclosures declining and no-bids being used less frequently, no-bids fell by 34 percent, from 11,391 in fiscal-year 1988 to 7,467 in fiscal-year 1989. While some of this improvement was due to the increased use of the buy-down option by mortgage servicers, it was still encouraging to see the decline in no-bids, especially for mortgage bankers, who service an estimated 70 to 75 percent of all VA loans.



In contrast to the stability in direct expenses and the decline in provision for loan losses, the amortized cost of purchased servicing increased 40 percent to $66 per loan in 1989 from $47 per loan in 1988. With this increase, the ACPS rose to 12 basis points as a percent of the dollar volume serviced. While there was quite a bit of variation in the ACPS from firm to firm, the larger the servicing portfolio, the higher the share of purchased servicing (see Table 5). This is in contrast to the sale of servicing rights, which, on a per-loan basis, tended to be highest at the smaller firms. Taken together, it appeared that small firms tended to be net sellers of servicing rights, while the large firms were usually the net purchasers.

Economies of scale

Once again economies of scale were clearly evident in servicing. Table 5 shows that firms with large servicing portfolios tended to have higher levels of productivity and lower direct costs. For instance, at firms with servicing portfolios of less than $500 million, the number of loans serviced per servicing employee was only 384, while for firms with servicing portfolios in excess of $4 billion, the number of loans serviced per servicing employee was 750. As expected, these differences in productivity carried through to lower costs, with total direct expenses declining from $150 per loan for the smallest servicers to $81 per loan for the largest servicers. Within direct expenses, these cost trends held true for most of the key components, including personnel, occupancy and EDP.

Further evidence of economies of scale could be seen by grouping firms by the number of loans serviced per servicing employee. Firms servicing less than 400 loans per servicing employee tended to be relatively small, with servicing portfolios averaging less than $300 million. In contrast, at firms where the number of loans serviced per servicing employee was more than 700, the servicing portfolio averaged $5.4 billion. Again, the cost figures reflected the benefits of higher productivity. Direct expenses for the firms with the highest productivity in the survey were $67 per loan, only about one-third of the average for the lowest productivity group.

Organizational structure

In 1989, as in past years, the profitability of the servicing operation varied by type of business structure (see Table 6). As was the case in 1988, however, the servicing portfolios of privately held companies were more profitable than those at firms with other organizational structures. Net income expressed as a percent of the dollar volume serviced was 25 basis points, more than twice as high as thrift-institution and bank holding company subsidiaries. For these two institutional groups, net income was 12 basis points and 11 basis points, respectively, about the same as at the average firm in the survey. At non-bank, non-thrift subsidiaries ("other subsidiaries") net income was only 7 basis points.

Both higher-than-average servicing income and lower-than-average servicing costs contributed to the solid performance by privately held companies. As a percent of the dollar volume serviced, gross income at privately held companies was 47 basis points in 1989.

TABLE 3

Servicing Income and Expenses per Loan Serviced
Average Firm 1987-1989

	1989	1988	1987
INCOME			
Servicing Fees	$199.06	$183.60	$177.60
First Mortgages (1)	207.53	194.01	173.92
Other Mortgages	2.02	0.34	3.68
Amortization of Excess Servicing	-10.49	-10.75	N/A
Net Gain (Loss) on Sale of REO	-2.25	-1.96	-5.08
Other Loan Administration Income	35.97	29.80	23.79
Total Servicing Income	$232.78	$211.44	$195.81
Net Gain (Loss) on Sale of Servicing	44.30	66.97	N/A
Total Serv Income, Incl Sale of Serv	$277.07	$278.41	N/A
EXPENSES			
Personnel	$35.25	$37.63	$40.84
Loan Administration Employees	29.05	31.54	35.06
Other Personnel Expenses	0.66	N/A	N/A
Fringe Benefits	5.43	5.94	5.63
Education and Training	0.11	0.15	0.15
Occupancy	5.14	5.67	[illegible].38
Electronic Data Processing	7.78	8.69	10.14
Other Direct Expenses	40.34	35.56	41.46
Expenses to Service Foreclosures & REO	7.91	8.07	15.14
Corporate Interest Losses on MBS Pools	3.78	2.99	N/A
Non-EDP Depreciation	1.54	1.22	1.57
All Other Direct Expenses	27.10	23.28	24.75
Total Direct Expenses	$88.51	$87.55	$97.82
Provision for Loan Losses	17.05	27.39	13.41
Amortized Cost of Purchased Servicing	65.85	47.14	47.09
Net Servicing Income (Before Tax)	$61.37	$49.36	$37.49
Memorandum Items:			
Profit Margin	26.4%	23.3%	19.1%
Profit Margin, Incl Sale of Servicing	38.1%	41.8%	N/A
Servicing Income as a % of $ Vol Serv	0.425	0.451	0 428
Servicing Fees as a % of $ Vol Serv	0.363	0.392	0.388
Servicing Expense Ratio (2)	0.162	0.187	0.214
Number of Firms Reporting	145	114	124

(1) Servicing fees on first mortgages represent gross servicing fees.
Prior to 1988 they represented servicing fees on first mortgages less amortization of excess servicing.
(2) Total Direct Expenses as a percent of dollar volume serviced.

Thrift institution subsidiaries we next at 46 basis points. They were f lowed by non-bank, non-thrift su sidiaries at 44 basis points. Finall servicing income at bank holding cor panies was only 39 basis points.

This high income level at private held companies reflects above-ave age- servicing fees—39 basis poin compared to 36 basis points at the a erage firm—and high-loan-balanc loans. The average size loan service by privately held companies wa $63,892. For the other three owne ship groups, the average size loan se viced ranged from $50,628 to $55,123.

Total servicing expenses for privat ly held companies, expressed as a pe cent of the dollar volume service were only 23 basis points, compared t 31 basis points at the average firm. A bank holding company subsidiarie total servicing expenses were 28 bas points, while at thrift subsidiaries the were 34 basis points, and finally, a non-bank, non-thrift subsidiaries, tot expenses were 37 basis points.

Within expenses, the low per-loa cost for purchased servicing distir guished the privately held companie from the other ownership groups. A privately held companies the ACP was only 4 basis points. This is les than half of what it was at thrift sub sidiaries, the next-closest ownershi group, and one-third that of the aver age firm. This difference in ACPS i consistent with the results by firn size. The servicing portfolios at pr vately held companies were abou $750 million, and smaller firms tende not to be active purchasers of servic ing rights. Direct expenses at private ly held companies were 16 basi points, the same as at the averag firm, but 2 basis points higher tha bank holding company subsidiaries At non-bank, non-thrift subsidiaries di rect expenses were 17 basis points and at thrift subsidiaries they were 2

TABLE 4

Personnel Expenses
Average Firm 1985-1989

	1989	1988	1987	1986	1985
No. of Loans Serviced per Serv Employee	696	616	570	549	579
Average Salary Loan Admin. Personnel	$24,541	$18,978	$18,324	$16,774	$15,187
Personnel Expenses per Loan Serviced	$35.25	$37.64	$40.84	$37.62	$33 58
Personnel Expenses as a % of $ Vol Serv	0.064	0.080	0.089	0.091	0.090
Per. Expenses as % of Direct Serv Exp.	39.8	43.0	42.0	45.0	51.0

basis points. Provision for loan losses as a percent of the dollar volume serviced was about 3 basis points for all four ownership groups.

High-profit firms

The 10 repeat reporters whose overall profit margin was the highest in the survey in 1989 clearly distinguished themselves in servicing (see Table 7). Compared to the average firm, total servicing income was 22 percent higher, while total expenses were 19 percent lower. This combination of higher revenues and lower costs yielded a net income figure of $145 per loan, more than twice as high as the $61 per loan figure for the average firm. Moreover, net income as a percent of servicing volume was 24 basis points for the high-profit firms versus 11 basis points at the average firm.

Total servicing income for these 10 firms was $283 per loan compared to $233 per loan at the average firm. The main reason for this difference was the size of the average loan serviced by the high-profit firms. At $61,289, the average-size loan serviced by these 10 firms was 12 percent larger than at the average firm. Consequently, servicing fee income was $226 per loan for the

TABLE 5

1989 Servicing Income and Expenses per Loan Serviced Grouped by Dollar Volume of Loans Serviced (In Billions)

	Less than $0.500	$0.500 to $0.999	$1 to $3.999	$4 or More	Average Firm
INCOME					
Servicing Fees	$229.62	$172.11	$211.73	$196.42	$199.06
First Mortgages (1)	233.11	182.65	224.99	203.63	207.53
Other Mortgages	3.89	0.27	2.05	2.07	2.02
Amortization of Excess Servicing	−7.38	−10.80	−15.31	−9.29	−10.49
Net Gain (Loss) on Sale of REO	−0.16	−1.44	−1.46	−2.63	−2.25
Other Loan Administration Income	59.74	27.84	30.65	37.01	35.97
Total Servicing Income	$289.20	$198.51	$240.92	$230.79	$232.78
Net Gain (Loss) on Sale of Servicing	100.81	160.27	96.94	17.78	44.30
Total Serv Income, Incl Sale of Serv	$390.02	$358.79	$337.86	$248.58	$277.07
EXPENSES					
Personnel	$69.62	$45.60	$37.26	$32.27	$35.25
Loan Administration Employees	58.18	38.23	31.01	26.43	29.05
Other Personnel Expenses	1.55	0.76	0.79	0.57	0.66
Fringe Benefits	9.52	6.44	5.34	5.19	5.43
Education and Training	0.36	0.16	0.13	0.08	0.11
Occupancy	8.34	7.43	4.76	4.91	5.14
Electronic Data Processing	14.49	10.51	8.97	6.93	7.78
Other Direct Expenses	57.29	46.80	49.95	36.40	[illegible]0.34
Expenses to Service Foreclosures & REO	6.08	9.56	5.08	8.64	7.91
Corporate Interest Losses on MBS Pools	3.75	3.25	3.46	3.92	3.78
Non-EDP Depreciation	3.86	2.22	1.78	1.31	1.54
All Other Direct Expenses	43.60	31.78	39.64	22.54	27.10
Total Direct Expenses	$149.74	$110.34	$100.94	$80.51	$88.51
Provision for Loan Losses	15.48	16.80	15.00	17.71	17.05
Amortized Cost of Purchased Servicing	19.08	21.87	32.75	80.65	65.85
Net Servicing Income (Before Tax)	$104.91	$49.50	$92.23	$51.92	$61.37
Memorandum Items:					
Servicing Fees (%)	0.431	0.372	0.357	0.361	0.363
Number of Loans Serv per Serv Employee	384	500	692	750	696
Average Loan Size Serviced	$53,220	$46,239	$59,282	$54,334	$54,786
Average Number of Loans Serviced	3,416	14,425	33,624	216,893	44,016
Average Dol Val of Servicing (Millions)	$182	$667	$1,993	$11,785	$2,411
Number of Firms Reporting	61	26	37	21	145

(1) Servicing fees on first mortgages represent gross servicing fees.
Prior to 1986 they represented servicing fees on first mortgages less amortization of excess servicing.

high-profit firms compared to $199 per loan at the average firm. Other servicing income was also quite a bit higher for these 10 firms.

Total servicing expenses for these firms, expressed as a percent of servicing volume, were only 23 basis points compared to 31 basis points for the average firm. Similarly, per-loan expenses were only $139 compared to $171 at the average firm. All three major cost areas were lower [illegible] the high-profit firms. But, the big difference was in the amortized cost of purchased servicing.

Direct expenses at the 10 firms were $83 per loan, 6 percent less than at the average firm. Within direct expenses, almost every key cost component was lower. Interestingly, the cost differential in this area does not reflect a higher level of productivity. The number of loans serviced per servicing employee, at 695, was almost identical to the productivity level of the average firm.

Problem-loan expenses at the high-profit firms were $23 per loan, 16 percent less than at the average firm. The key difference was in expenses to service foreclosures and REO. Both provision for loan losses and losses on sales of REO were very close to the survey average. Finally, these 10 firms were not active purchasers of servicing. As a result, their ACPS was only $38 per loan, compared to $66 per loan at the average firm.

Outlook

The future prospects for the servicing operation appear promising. Total servicing income per loan is likely to rise as the average loan size serviced continues to grow. Moreover, income generated from the sale of servicing rights will continue to increase in importance as more and more firms

TABLE 6

1989 Servicing Income and Expenses per Loan Serviced
Grouped by Type of Ownership

	Bank Holding Company Subsidiary	Thrift Institution Subsidiary	Other Subsidiary	Privately Held Company	Average Firm
INCOME					
Servicing Fees	$178.85	$198.68	$209.35	$248.93	$199.06
First Mortgages (1)	187.61	207.60	219.72	247.06	207.53
Other Mortgages	0.98	0.00	2.01	9.49	2.02
Amortization of Excess Servicing	−9.75	−8.91	−12.39	−7.62	−10.49
Net Gain (Loss) on Sale of REO	−1.49	−0.23	−1.90	−9.94	−2.25
Other Loan Administration Income	32.24	35.41	33.83	63.49	35.97
Total Servicing Income	$209.60	$233.87	$241.28	$302.48	$232.78
Net Gain (Loss) on Sale of Servicing	38.57	57.95	36.53	87.71	44.30
Total Serv Income, Incl Sale of Serv	$248.18	$291.82	$277.81	$390.19	$277.07
EXPENSES					
Personnel	$28.68	$43.76	$38.14	$42.43	$35.25
Loan Administration Employees	23.67	36.18	31.10	36.09	29.05
Other Personnel Expenses	0.20	1.11	0.97	0.88	0.66
Fringe Benefits	4.71	6.25	6.00	5.28	5.43
Education and Training	0.10	0.21	0.06	0.18	0.11
Occupancy	3.38	6.01	6.67	5.55	5.14
Electronic Data Processing	6.76	8.23	8.33	9.57	7.78
Other Direct Expenses	33.88	53.21	42.94	42.68	40.34
Expenses to Service Foreclosures & REO	8.72	8.91	6.66	8.37	7.91
Corporate Interest Losses on MBS Pools	3.06	4.06	4.51	3.66	3.78
Non-EDP Depreciation	1.27	3.15	1.26	1.95	1.54
All Other Direct Expenses	20.83	37.09	30.52	28.70	27.10
Total Direct Expenses	$72.70	$111.21	$96.08	$100.24	$88.51
Provision for Loan Losses	17.25	14.95	17.09	18.67	17.05
Amortized Cost of Purchased Servicing	59.07	45.51	88.23	25.37	65.85
Net Servicing Income (Before Tax)	$60.58	$62.20	$39.89	$158.20	$61.37
Memorandum Items:					
Servicing Fees (%)	0.333	0.392	0.380	0.390	0.363
Number of Loans Serv per Serv Employee	776	594	665	587	696
Average Loan Size Serviced	$53,658	$50,628	$55,123	$63,892	$54,786
Average Number of Loans Serviced	64,207	28,727	79,636	11,727	44,016
Average Dol Val of Servicing (Millions)	$3,445	$1,454	$4,390	$749	$2,411
Number of Firms Reporting	41	25	31	48	145

(1) Servicing fees on first mortgages represent gross servicing fees.
Prior to 1986 they represented servicing fees on first mortgages less amortization of excess servicing.

> Total servicing income per loan is likely to rise as the average loan size serviced continues to grow.

make this a standard part of their servicing operation.

But the noteworthy future developments are likely to be on the cost side. In an effort to increase operating efficiency, mortgage servicers are likely to continue incorporating new technology into the everyday work environment. This should result in further gains in productivity, as well as lower direct costs. While delinquency and foreclosure problems are likely to remain a significant factor, the increased emphasis on quality control hopefully will keep costs in this area to a minimum. Thus on the whole, efficient servicers can expect continued improvement in net servicing income in the years ahead. **MB**

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TABLE 7

Servicing Income and Expenses per Loan Serviced
Ten High-Profit Firms 1988-1989

	1989	1988
INCOME		
Servicing Fees	$225.90	$165.20
First Mortgages (1)	249.62	184.27
Other Mortgages	0.00	0.00
Amortization of Excess Servicing	−23.72	−19.07
Net Gain (Loss) on Sale of REO	−1.94	−1.43
Other Loan Administration Income	59.06	20.81
Total Servicing Income	$283.03	$184.58
Net Gain (Loss) on Sale of Servicing	61.14	27.77
Total Serv Income, Incl Sale of Serv	$344.17	$212.35
EXPENSES		
Personnel	$34.00	$33.57
Loan Administration Employees	28.01	28.38
Other Personnel Expenses	0.52	N/A
Fringe Benefits	5.30	5.02
Education and Training	0.18	0.18
Occupancy	3.96	2.81
Electronic Data Processing	7.24	5.21
Other Direct Expenses	37.60	36.50
Expenses to Service Foreclosures & REO	3.68	13.23
Corporate Interest Losses on MBS Pools	3.63	6.55
Non-EDP Depreciation	1.29	0.93
All Other Direct Expenses	29.00	15.79
Total Direct Expenses	$82.81	$78.09
Provision for Loan Losses	17.26	26.05
Amortized Cost of Purchased Servicing	38.46	36.16
Net Servicing Income (Before Tax)	$144.5[illegible]	$44.28
Memorandum Items:		
Servicing Fee (%)	0.369	0.389
Number of Loans Serv per Serv Employee	695	667
Average Loan Size Serviced	$61,289	$42,481
Average Number of Loans Serviced	28,408	33,615
Average Dol Vol of Servicing (Millions)	$1,741	$1,426
Number of Firms Reporting	10	10

(1) Servicing fees on first mortgages represent gross servicing fees.
Prior to 1988 they represented servicing fees on first mortgages less amortization of excess servicing.

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ECONOMIC TRENDS

Each month, a new batch of housing market statistics is released that provides essential gauges on how the housing sector is doing. Three of the most important releases are housing starts, new home sales and existing home sales. The first of these is produced by the U.S. Department of Commerce; the second is produced jointly by the U.S. Department of Commerce and the U.S. Department of Housing and Urban Development; the final one is prepared by the National Association of Realtors (NAR).

Each one has something a little different to say about the housing sector.

Housing starts—The housing starts report, released around the middle of each month with results from the preceding month, provides data on building permits and housing starts by number of units (e.g., 1-unit, 2-4 units and 5-units or more) and by major census region (e.g., Northwest, Midwest, South and West).

The data are collected through a monthly Census Bureau survey. The process begins by soliciting information on building permits from local governments. Then, a sample of permits is selected, and the owners and/or builders holding the permit are asked if the unit has been started. A unit is considered started when excavation begins for the footings or fou[illegible]on. In the case of multifamily units, all units are cons[illegible] started once excavation for the building begins.

If units covered by permits have not yet been started, follow-ups are made to determine if and when a start occurs. Otherwise, the start appears in the housing starts statistics in the survey month. Roughly 60 percent of single-family units are started in the same month in which a permit is issued. However, only about 35 percent of structures with 5-units or more are started in the same month.

New home sales—The survey underlying housing starts is also used in estimating new home sales. In the new home sales report, the number of sales, units for sale and sales prices are reported each month, with the number of sales and units for sale further broken down by region.

The estimates are made by first classifying single-family housing starts into one of four categories:

- "Spec built," where the land and structure are for sale as a unit.
- The unit is being built for the owner on the owner's land by a general contractor.
- The unit is being built on the owner's land with the owner serving as the general contractor.
- Units built for rent.

The first category accounts for about two-thirds of single-family starts and, in this classification scheme, is also the only category associated with new home sales. Consequently, new home sales are a subset of housing starts.

That is not to say, however, that the timing of starts and sales is exactly the same. As noted, a start is recorded once excavation begins. However, a new home sale is recorded when a sales contract has been signed or a deposit has been accepted. Consequently, a sale may be recorded when a couple signs a contract for an unbuilt house after looking at models—a case where the sale would lead the start—or they could buy the model or another completed unit—a case where the start leads the sale. In any case, the two—starts and sales—will ultimately be linked.

Existing homes sales—Existing home sales are based on compilations of transactions reported to NAR by over 550 boards of Realtors across the country. Data on number of units and prices are reported by region each month.

The transactions are not all reported on the same basis. Some boards report transactions as of the signing of a contract, others report transactions at the time of closing. Consequently, in any given month, existing home sales reflect both contracts signed in that month and some of those signed in the preceding few months.

Table 1 shows the three major indicators for the past six years or so. Both single-family housing starts and new home sales peaked in 1986, and are currently 25 to 30 percent below their respective peaks. Existing home sales, on the other hand, peaked in 1988 (although the 1988 peak was only very slightly greater than the 1986 level), then came down, but have since revived to very close to the previous peak.

One possible reason for the discrepancy between new construction—reflected by starts and new home sales—and transactions of already existing units—reflected by existing home sales—is that the latter units tend to be much more moderately priced. The median price of new homes is around $120,000, but the median price of existing homes is only about $102,000. It is possible that affordability constraints pushed more and more buyers away from new homes in the late 1980s and early 1990s, and toward more moderately priced existing homes. That would explain both the lackluster performance in the new home market and the relative stability in the existing home market.

Thomas M. Holloway
Senior Economist

TABLE 1

	Millions of Units, Unless Otherwise Noted		
Year	**Single-Family Housing Starts**	**New Home Sales**	**Existing Home Sales**
1985	1.072	.688	3.214
1986	1.179	.750	3.565
1987	1.146	.671	3.526
1988	1.081	.676	3.594
1989	1.003	.650	3.440
1990	.895	.534	3.296
1991 June	.868	.525	3.590
Percent change, peak to June 1991	−26.4%	−30.0%	−.1%

VITAL STATISTICS

KEY ECONOMIC INDICATORS AND INTEREST RATES

	CHANGES IN PAYROLL EMPLOYMENT (THOUSANDS)	UNEMPLOYMENT RATE (%)	CHANGES IN CONSUMER PRICES FROM YEAR AGO LEVELS (%)		MORTGAGE INTEREST RATES (%)		
			ALL ITEMS	ALL ITEMS LESS FOOD AND ENERGY	SECONDARY MARKET YIELD ON FHA NEW HOME MORTGAGES[1]	FHLMC ARMs	FHLMC FRMs
JUL-90	−166	5.5	4.8	5.0	10.15	8.43	10.04
AUG-90	−109	5.6	5.6	5.5	10.20	8.35	10.10
SEP-90	−47	5.7	6.2	5.5	10.26	8.28	10.18
OCT-90	−131	5.7	6.3	5.3	10.24	8.21	10.18
NOV-90	−221	5.9	6.3	5.3	10.02	8.10	10.01
DEC-90	−140	6.1	6.1	5.2	9.74	7.93	9.67
JAN-91	−203	6.2	5.7	5.6	9.62	7.74	9.64
FEB-91	−258	6.5	5.3	5.6	9.58	7.65	9.37
MAR-91	−258	6.8	4.9	5.2	9.59	7.47	9.50
APR-91	−166	6.6	4.9	5.1	9.61	7.38	9.49
MAY-91	151	6.9	5.0	5.1	9.62	7.22	9.47
JUN-91	−21	7.0	4.7	5.0	9.67	7.24	9.62
JUL-91	−51	6.8	NA	NA	NA	7.23	NA

RATES ON SELECTED SECURITIES (%)

	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	U.S. GOVERNMENT 1-Year	U.S. GOVERNMENT 3-Year	U.S. GOVERNMENT 10-Year	A-Rated Utility
JUL-90	8.15	7.99	7.52	7.94	8.26	8.47	9.96
AUG-90	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP-90	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT-90	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV-90	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC-90	7.31	7.80	6.70	7.05	7.47	8.08	9.95
JAN-91	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB-91	6.25	6.49	5.93	6.27	7.08	7.85	9.54
MAR-91	6.12	6.41	5.92	6.40	7.35	8.11	9.58
APR-91	5.91	6.07	5.71	6.24	7.23	8.04	9.46
MAY-91	5.78	5.92	5.61	6.13	7.12	8.07	9.45
JUN-91	5.90	6.11	5.75	6.36	7.39	8.28	9.53
JUL-91	NA	NA	NA	NA	NA	NA	NA

CURRENT SECONDARY MARKET YIELDS (%)

	GNMA[2]	FNMA[2]	FHLMC[2]
JUL-90	9.66	9.66	9.66
AUG-90	9.80	9.75	9.75
SEP-90	9.86	9.79	9.73
OCT-90	9.84	9.80	9.69
NOV-90	9.63	9.66	9.54
DEC-90	9.22	9.27	9.16
JAN-91	9.17	9.24	9.12
FEB-91	8.81	8.86	8.77
MAR-91	9.00	9.03	8.93
APR-91	8.95	8.98	8.88
MAY-91	8.94	8.95	8.86
JUN-91	9.16	9.18	9.06
JUL-91	9.14	9.17	9.06

SPREADS

(Basis Points)

	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
JUL-90	119	119	119
AUG-90	105	100	100
SEP-90	97	90	84
OCT-90	112	108	97
NOV-90	124	127	115
DEC-90	114	119	108
JAN-91	108	115	103
FEB-91	96	101	92
MAR-91	89	92	82
APR-91	91	94	84
MAY-91	87	88	79
JUN-91	88	90	78
JUL-91	NA	NA	NA

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED

By Type of Institution and By Type of Unit

(Millions of Dollars)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies
JUL-90	38,624	14,990	12,020	11,203	30	1,873	257	871	395	209	14,327	4	476	10,724	2,984
AUG-90	41,054	14,948	12,940	12,710	34	2,629	100	950	1,296	92	20,513	1,258	650	15,178	2,994
SEP-90	36,091	13,871	10,616	11,174	36	1,705	177	854	307	112	17,676	25	576	13,623	3,343
OCT-90	36,570	12,834	11,324	12,013	37	1,965	207	840	689	28	14,120	0	551	10,327	3,041
NOV-90	32,958	13,104	8,750	10,716	43	2,157	211	669	970	122	16,557	0	580	12,618	3,288
DEC-90	29,339	11,380	8,500	9,089	39	2,904	184	760	1,360	349	19,156	0	703	13,695	3,705
JAN-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUL-90	1,155	907	248	1,086	839	247	115	226	492	322	115	228	421	322
AUG-90	1,131	865	266	1,055	817	238	122	240	434	335	114	221	405	315
SEP-90	1,106	893	213	989	778	211	104	239	445	318	111	218	385	275
OCT-90	1,026	861	165	925	747	178	144	230	392	260	114	194	360	257
NOV-90	1,130	823	307	916	710	206	147	232	483	268	108	194	366	248
DEC-90	971	768	203	854	689	165	110	233	395	233	99	181	338	236
JAN-91	847	677	170	802	651	151	86	167	361	233	96	188	306	212
FEB-91	992	825	167	876	739	137	91	301	384	216	99	205	353	219
MAR-91	907	770	137	892	734	158	104	226	390	187	96	204	340	252
APR-91	977	833	144	913	787	126	93	236	395	253	102	210	361	240
MAY-91	989	868	121	966	801	165	114	217	367	291	105	221	379	261
JUN-91	1,040	898	142	999	834	165	148	255	389	248	115	227	391	266
JUL-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOME SALES

(Units and Prices in Thousands)

	EXISTING HOMES		NEW HOMES		
	Sold (SAAR)	Median Sales Price (Dollars)	Sold (SAAR)	Median Sales Price (Dollars)	Months Supply At Current Sales Rate
JUL-90	3,320	98.1	541	118.7	8.0
AUG-90	3,410	97.2	525	118.4	8.1
SEP-90	3,160	94.4	504	113.0	8.4
OCT-90	3,070	92.9	465	120.0	8.7
NOV-90	3,150	92.0	480	118.9	8.2
DEC-90	3,130	91.7	464	127.0	8.4
JAN-91	2,900	95.6	414	117.9	9.3
FEB-91	3,160	94.0	488	119.9	8.0
MAR-91	3,220	98.2	495	122.5	7.5
APR-91	3,310	100.3	505	120.7	7.3
MAY-91	3,540	101.1	489	117.1	7.5
JUN-91	3,590	101.9	525	120.0	6.9
JUL-91	NA	NA	NA	NA	NA

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

	Total[5]	1-Unit	2+ Units	Nonresidential
JUL-90	309.1	97.3	17.1	112.5
AUG-90	301.3	95.3	17.4	106.6
SEP-90	296.7	92.8	16.9	105.6
OCT-90	291.3	90.9	16.7	102.6
NOV-90	285.2	88.0	16.1	100.0
DEC-90	280.6	85.7	16.9	98.5
JAN-91	274.1	81.8	16.3	95.0
FEB-91	270.9	78.6	15.6	96.1
MAR-91	264.5	76.3	15.4	93.3
APR-91	267.9	76.4	14.4	97.5
MAY-91	261.2	80.2	13.9	88.2
JUN-91	261.2	83.8	13.4	84.3
JUL-91	NA	NA	NA	NA

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Securities for 0- to 30-day delivery.

[3] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[4] Savings & Loans and Mutual Savings Banks.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

OCTOBER 1991

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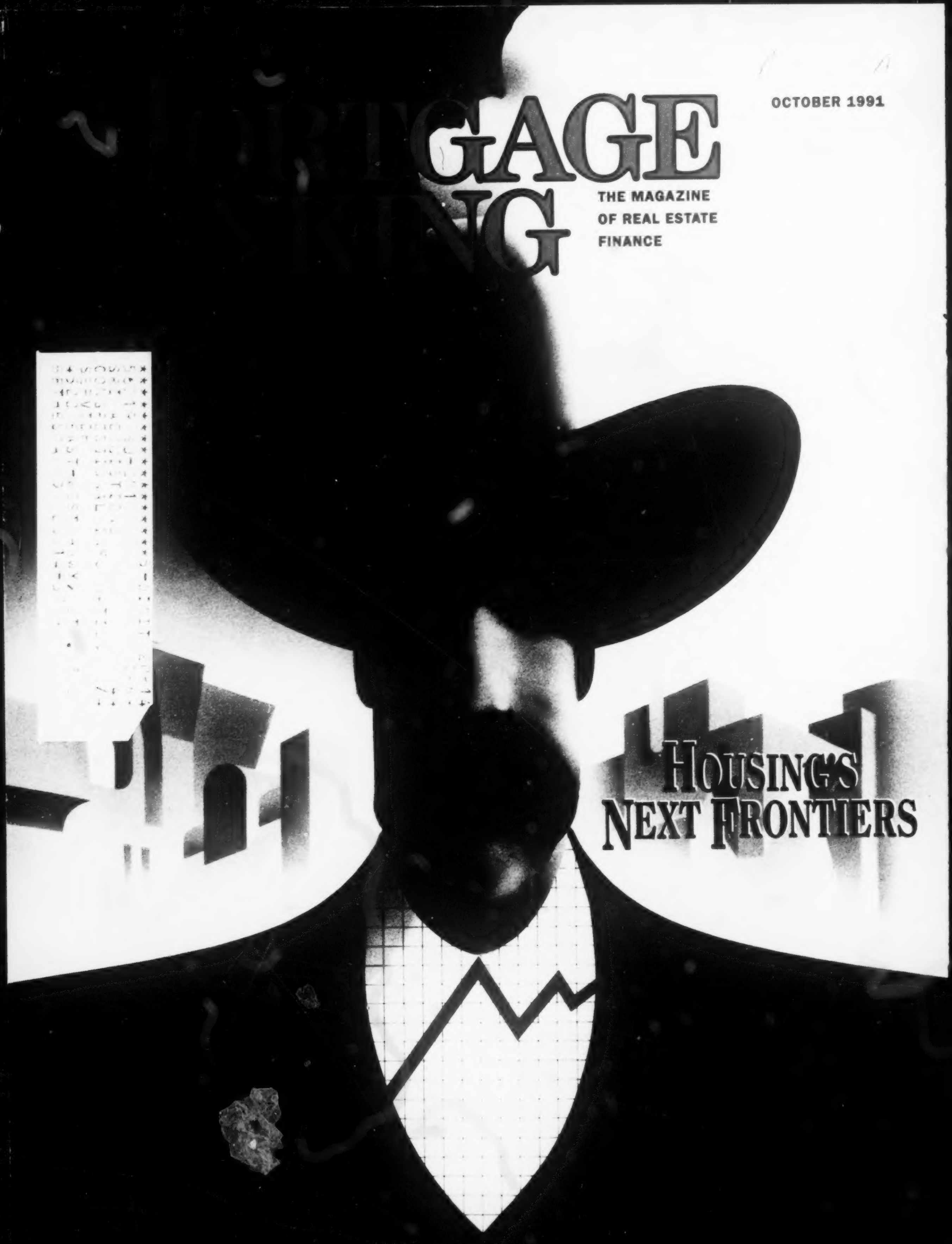

HOUSING'S NEXT FRONTIERS

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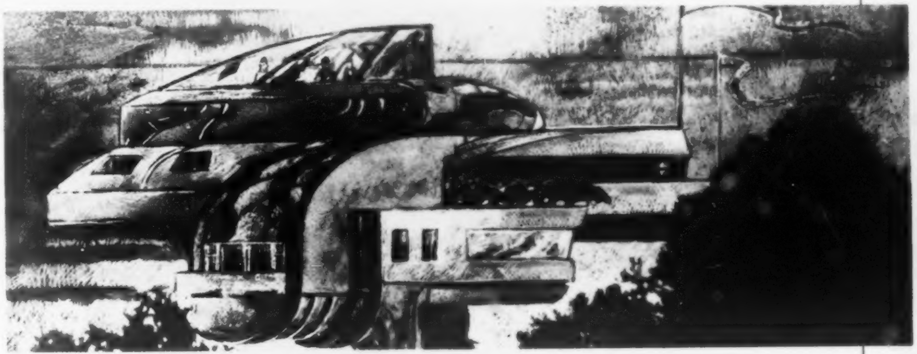

COVER:
Housing's Next Frontiers

"The farthermost limits of knowledge or achievement in a particular subject." That's how one dictionary defines frontier. This issue is an attempt to stake out some of those outermost reaches of knowledge in the field of housing. We tackled housing policy, mortgage product design and what the tea leaves are suggesting about tomorrow's hot regional markets. Altogether, we hope it provides a tiny glimpse at housing's future.

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PORTFOLIO

Exploring New Territory

Housing policy has come a long way since 1862. But unfortunately while it's gotten more complex it's also gotten arguably less effective. Granted, it would be hard for HUD to compete with a policy that basically said find a piece of land in the public domain, live on it and work it, and BING—it's yours. That was the Homestead Act—back when federal policymakers really knew how to make policy. Call it a giveaway program, the quintessential sweat equity program or the ultimate affordability program. Call it what you want, it worked.

Unfortunately, the government has no vast unsettled acreage to give away any more. And today, finding policy solutions that open up homeownership to working Americans of very modest means is a much more formidable challenge. Unfortunately, we live in a world where decades of housing appreciation have outpaced wage inflation and tradeup buyers with wallets full of equity money have spiked housing prices through the roof. The open door policy of easy access to homeownership is the stuff of a bygone era.

Now, it's time for tackling the next frontier—the financial markets equivalent of a new Homestead Act. But how and with what—our government is no longer a land-rich, benevolent, emerging industrial power—it's in hock up to its elbows borrowing from foreign investors by the billions to pay the bills. Land is not free and money costs a lot of money.

This is where the challenge comes in for the engineers of mortgage credit. Like the early policymakers you have to look at what the need is and what the supply is, and then find a way to bring the two together. Like the vast acres of unsettled prairie land in the 1860s, today we can tap the world's capital for mortgage credit and it remains in ample supply—thanks largely to Fannie Mae and Freddie Mac and GNMA. But the incomes and the cash down payments and affordably priced housing stock clearly are in short supply. So, the industry must explore new and untraditional mortgage products and underwriting rules to get working people with stable jobs and solid credit into homes.

That is just one of the frontiers being explored today by some modern-day pioneers in this industry. We hope this issue will offer other insights into the ways housing can be made possible for a deeper cross section of American society. The days of direct giveaway programs are clearly over, but in other ways, housing's frontiers are still wide open.

Janet Reilley Hewitt
Editor in Chief

COMING IN NOVEMBER

In November, the topic is marketing and what keeps the customers coming back. We will look at Countrywide's quality service survey, see how one bank promotes a service culture and talk to Freddie Mac's top marketing person.

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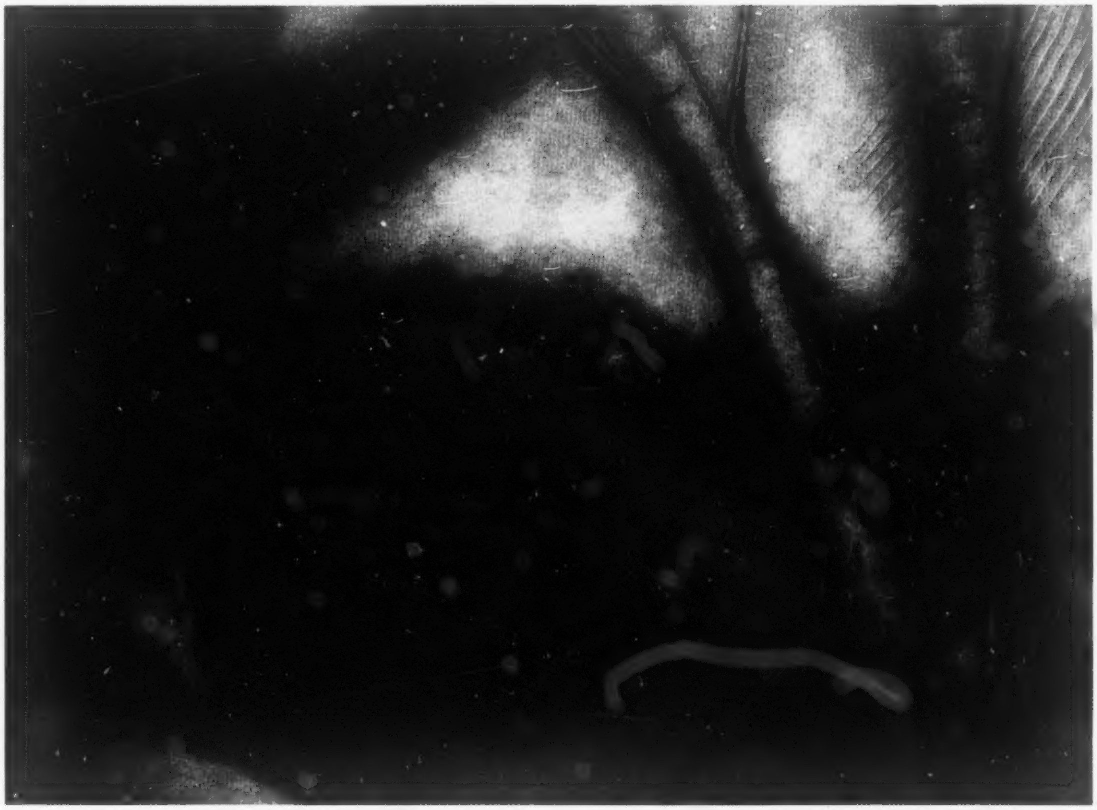
SCOUTING OUT NEW MARKETS



Regional housing markets have undergone recessionary strains that have recast the fundamental makeup of many. New opportunities are out there, but they are sometimes hidden—and blazing a trail to find the most profitable markets takes well-grounded facts and expert guidance.

Robert Hopkins

ILLUSTRATION BY LINA CHESAK

As the nation slowly pulls out of the recession that began in the summer of 1990, mortgage lenders, real estate agents, builders and homeowners anxiously await recovery in their local housing markets. Evidence is already accumulating that the market for new and existing housing bottomed early this year, at the beginning of the new building season, and has been slowly, though unevenly, improving ever since.

But, recovery in a national sense may not lead to an evenly distributed recovery in all parts of the country or in all facets of the housing market. This is especially true because this particular economic recovery is expected to be modest and slow. A very robust recovery would tend to boost most markets, as happened during the 1980s. But a modest recovery—especially one at the beginning of what will turn out to be a slow housing decade—will leave some areas without much improvement at all. "Competition" for recovery among regions or sectors may prove a dominant theme during the next few years. Thus, even among those who believe the economy is on its way back and will not retrench with a double dip, there is uncertainty about how individual regions will fare.

It is hazardous enough to try to predict the national economic future during cyclical changes. But on a local level, given the limited availability and poor quality of economic data, it is sometimes difficult to even understand the past. Nevertheless, it is the local, not national, recovery that generally affects small builders, Realtors, mortgage bankers and individual homeowners. As a result, regional analysts are constantly being asked to speculate on trends in individual areas. This article will present some issues relating to relative local housing performance, show some historical data and offer some limited expectations for future recovery.

To understand how a local housing market can deviate from national trends, we need to look at several different aspects of housing supply and demand. Changes in the national economy affect various regions differently depending on the local economic forces that prevail. In addition, every region of the country entered this recession with a slightly different history, particularly regarding how each region fared during the so-called "rolling" recession during the 1980s. Individual regions will react to the housing market differently, because of fundamental changes in general housing characteristics including how it is financed. Finally, as a part of the overall real estate sector, housing is not immune to the problems facing commercial real estate. The crisis in commercial real estate has, and will continue to have, regional implications that, to some extent, will cross over to the housing market.

Recovery in a national sense may not lead to an evenly distributed recovery in all parts of the country or in all facets of the housing market.

Local economic forces

First and foremost among differences in local housing markets is the overall health and status of the local economy in the current environment. Strong employment growth, low unemployment rates and rising incomes will lead to a strong real estate market. The converse is true for cities that are lagging in these factors.

Local economies are fundamentally driven by the fortunes of the types of industries that are located there. For example, the "Massachusetts miracle" of the mid-1980s was largely the result of the strong national demand for electronics, mini-computers and defense products that were designed or made in that state. When those industries grew strongly, decades of job losses and out-migration were reversed in the state. The economy was also helped by the rise in financial services, which mainly benefited New York City and Los Angeles, but also expanded the financial center in Boston. From this national base of demand for Massachusetts products and services, the local economy grew healthy and wealthy. Housing values soared and construction and rehabilitation expanded into New Hampshire and Rhode Island.

By 1987, it became increasingly clear that the growing demand was for computers in smaller and cheaper boxes than the ones made in the high-tech ring around Boston. At the same time, the defense equipment business had peaked and financial services companies were rocked by the stock market crash. Massachusetts fell into a major recession that continues today with no obvious sign of ending soon. Housing prices have fallen significantly and construction has been reduced to a minimum. It is unlikely that the improvement in the national housing market that is evident already and is likely to continue during the next 12 months will pull New England housing out of its slump.

Long-term structural factors

Over the long term, the economic structure that is destiny in the short term will evolve. In fact, it was evolution from textile manufacturing to high technology that brought Boston to its boom status in the 1980s. It is extremely difficult to predict changes in the long-term structure of local economies, but some general comments can be made. It is likely that the long-term factors that have pulled the U.S. population to the South and to the West will continue throughout the rest of the 1990s. Thus, we can expect continued growth in the Southeast from North Carolina to Florida; in the Southwest from Texas to Nevada and on the West Coast. The attraction of the Sun Belt will necessitate significant housing construction in those areas for years to come. Some of the attraction has been diverted to the Northwest aided by the cyclical strength of the aircraft industry in Seattle. Other areas that were havens of escape to more "natural" surroundings during the 1970s may not experience such rejuvenation during the 1990s. Colorado has struggled through the last half of the 1980s despite its great attractiveness and may continue to lag during the 1990s.

If the Sun Belt continues to "win," in the race for recovery, the older parts of the country in the Northeast and near the Great Lakes will "lose." This is especially true because of the likely slower growth in the overall number of households during the 1990s. With fewer new households, it is more likely that gains in one area will come from absolute declines in other areas.

On a micro scale, long-term trends will continue to favor the suburban areas. This is especially true of large suburban concentrations that effectively function as total communities, such as those in New Jersey, or in Riverside and San Bernardino counties in California. The aging of the baby boom has pushed more and more people into the time of their lives when their children are growing older. Similar to the 1950s, the suburban school district, now supplemented by the suburban office park, holds a strong attraction for these families. Meanwhile, the urban problems, highlighted by the spread of crack cocaine and homelessness, as well as greater awareness of crumbling public infrastructure, will hurt the appeal of the central cities, unless another financial services-type boom takes over.

Such considerations might appear outside the focus of this article, because the topic we set out to address is the regional view of the recovery from the current recession. Yet, it is easier to start construction or to buy a house in a market with long-term growth prospects than in one that is likely to have long-term troubles. Overbuilding has traditionally been a problem in the hot growth markets, such as those in Florida or Arizona. In the current environment, the financial crunch, combined with regulatory restrictions such as statwide infrastructure requirements in Florida, limit the short-run likelihood of overbuilding.

> **The crisis in commercial real estate has, and will continue to have, regional implications that, to some extent, will cross over to the housing market.**

Status of the regional economic cycle

The rolling recession that occurred during the 1980s means that the nation entered the 1990-1991 national recession with a number of regions already in or on the way out of an earlier local recession. Whether or not an area has been hit by prior local recessions in recent times will continue to affect how that area fares during this national downturn.

The most extreme example is Houston. When oil prices stopped rising in 1982, the end of the real estate boom in Houston was evident. When global oil prices plummeted in 1986, Houston was thrown into a major depression. Since bottoming out in early 1987, however, the economy of Houston has slowly improved. This slow, steady recovery has helped Houston avoid job losses associated with the 1990 contraction. In fact, Houston was the leading metropolitan area in terms of job gains among all large metropolitan areas. The area produced 27,000 new jobs between June 1990 and June 1991. While 27,000 new jobs is a modest gain for a major city (Los Angeles was

TABLE 1

Single-Family Permit Issuance in 1991 by Metropolitan Statistical Area Compared to Peak 1985-89 and Trough 1980-83 Issuance (In Thousands)

Metropolitan Areas Ranked by absolute change from 1985-89 peak year	**1991 Single-Family Permits**	**Rank Among 100 MSAs**	**Change From 1985–89 Peak Years**				**Change From 1980–82 Recession Trough Years**	
			Number of Permits	**Rank**	**% Change**	**Rank**	**Number of Permits**	**Rank**
Top Ten								
Houston, TX	12.9	9	4.5	1	54	1	−6.2	100
Louisville, KY-IN	5.2	40	1.7	2	51	2	3.8	28
Las Vegas, NV	14.3	6	1.6	3	13	17	11.3	2
Indianapolis, IN	7.9	22	1.3	4	20	11	6.4	7
Milwaukee, WI	4.5	44	1	5	28	8	3.5	32
Columbus, OH	7.3	25	0.9	6	15	14	5.2	13
Portland, OR	6.4	31	0.9	7	15	13	4.3	25
Omaha, NE-IA	3	60	0.7	8	33	4	1.9	48
Greenville-Spartanburg, SC	3.6	50	0.6	9	22	10	2.1	46
Tulsa, OK	2.6	67	0.6	10	32	5	0.3	86
Bottom Ten								
Middlesex-Somerset-Hunterdon, NJ	2.7	63	−7.2	91	−73	97	0.6	79
San Diego, CA	9.1	19	−7.5	92	−45	72	5.4	12
Atlanta, GA	27.1	1	−8	93	−23	47	14.1	1
Monmouth-Ocean, NJ	3.5	52	−8.5	94	−71	94	−0.1	92
Tampa-St. Petersburg-Clearwater, FL	9.5	16	−8.6	95	−47	77	−0.9	96
Norfolk-Virginia Beach-Newport News, VA	6.8	27	−8.7	96	−56	84	3.1	37
Philadelphia, PA-NJ	11.6	11	−9.4	97	−45	71	5.7	10
Washington, DC-MD-VA	18.6	2	−13.1	98	−41	68	4.5	20
Los Angeles-Long Beach, CA	9.7	15	−14	99	−59	86	5.2	14
Riverside-San Bernardino, CA	17	3	−26.2	100	−61	89	8.6	4

adding 100,000 jobs a year before the recession), this increase shows dramatic improvement from 1986. Other oil-patch cities also are showing good relative performance.

A similar story holds true for the industrial Midwest. With the exception of the auto-industry hub cities, the industrial Midwest is performing relatively better during this recession than during prior downturns. The intense wringing out of manufacturing jobs in the early 1980s left many midwestern cities with little growth before 1987 or 1988. During this recession, manufacturing is suffering less than it normally does under similar conditions. Combined with the fact that much of the Midwest sat out the excesses of the 1980s, this relative lack of harm to manufacturing means that the current recession is hitting this region less than it might have under other circumstances. The Midwest has shown a history of not growing very fast even during good times. Also, for the size of the market, housing construction is limited. Thus, there will not be a boom in housing in that region such as one would expect in Florida, California or Nevada. Nevertheless, this housing recovery should prove better than normal in the Midwest. Unfortunately, the lingering automobile recession will hold back such auto-hub cities as Detroit, Toledo and Cleveland.

In contrast, the Northeast—from Boston to Washington—entered a financial services/high technology/defense recession two or three years ago (each city's recession started at different times) several years before the national recession began. Unfortunately, the independence of the Northeast recession will likely apply to the recovery as well. While many say the national economy has started to turn around, recovery in the Northeast is still in the future.

The national recession and the real estate crash may intrude on these independent economic cycles. For example, to return to the oil-patch example, part of the Houston late 1980s advantage was the relatively inexpensive office space available in that market. But with office rents falling everywhere, the relative advantage earlier enjoyed by Houston is now eroding. The Phoenix market enjoyed some benefits as a lower cost alternative to Los Angeles. Now that commercial rents are dropping in Los Angeles as well, this advantage has been diminished.

Changes in the structure of the housing market

One fundamental change in the housing market became apparent in the latter half of the 1980s. For example, the depression in the oil patch led to declines of a third or more in the value of houses in Houston. Then, drops of 20 percent or more were noted in New York City houses and coops. In New Hampshire, previous house prices now are no longer a guideline to current value. Whatever the reason for these declines—whether people hear about trends in these areas, read articles in *Barrons* or evaluate the long-term demographics of the baby-bust generation—the fundamental lesson is that a house may no longer be the best investment you can make. Houses are now homes, not high-yield investments. This means that the speculative demand for houses is gone, other than in some exceptional cases. Thus the investment demand for housing has been reduced. People used to view renting as throwing money away. But many homeowners, as a result of depreciation in some markets, have thrown an equal amount of money away recently. Others, in the past, bought houses because it was important to get on the bandwagon before they were left behind. Now, the bandwagon may not be moving at all, so getting on quickly is not a priority.

The fundamental lesson is that a house may no longer be the best investment you can make. Houses are now homes, not high-yield investments.

This is not to say that homeownership will decline in the next few years. Rather, certain housing markets that have been driven by speculation and expectations of rapidly rising prices will have to adjust. For example, consumers will evaluate moving to high-priced regions knowing that such a move may not yield spectacular capital gains down the road. This could hurt the extremely high-priced areas, such as San Francisco, Orange County, California or New York City. Also, while there will be continued demand for condominiums that cater to true needs, such as those of empty nesters who no longer wish to struggle with yard maintenance, the demand for ownership of purely apartment-like condominiums will diminish. Why buy a pure "apartment" when it is unlikely to increase in value and may even decrease? Such reluctance to buy at the bottom end of the market will depress trade-up activity and will hurt builders who have increasingly gravitated toward the luxury end of the market. The aging of the baby boom was supposed to have brought increasing demand for upscale housing. But for that demand to run its course, there needs to be a mechanism for baby boomers to sell their current homes and afford more expensive houses in the absence of the outlandish capital gains made in many regions during the 1980s.

Excesses

Each local market has a different history, ranging from prudent to excessive building, of commercial and residential real estate during the 1980s. The areas that are particularly susceptible to overbuilding will face a more difficult time during this recovery. Overbuilding will lead to a construction recession even if the local economy is already in a recovery. The local recession in Arizona—which never actually led to overall job losses, despite the preliminary employment reports to the contrary—was really a construction recession that is part of the normal overbuilding cycle in that area. The excessive number of planned housing developments around Phoenix, before 1988, still make it very difficult for a housing recovery to take hold in that region.

Local zoning requirements, environmental regulations or practical considerations, such as overcrowdedness or physical barriers, limit potential overbuilding in some areas. Construction in Seattle and coastal California has always been limited by all these factors. Thus, recovery does not await the absorption of excess inventory. While other considerations will limit the housing recovery in these areas, past overbuilding is not one of them.

In the current environment, the credit crunch is protecting every region from additional overbuilding. This may reduce regional variations in the future, but does not necessarily help the current environment.

Recent regional activity

As the modest and uneven recovery in the national housing market continues, the way that various regions have fared so far in the cycle provides a revealing view of how strong or weak the local housing markets are. Tables 1 and 2 demonstrate the leading and lagging housing markets by various measures.

The data presented in these tables show the number of permits issued for housing construction in Metropolitan Statistical Areas (MSAs) in the country. These data are the most comprehensive measures of housing construction in local areas. Housing construction in the first seven months of 1991 (the latest available data) lagged behind construction in the same period in 1990 in most areas of the country. However, a reasonable comparison between the two years is complicated by the fact that the first half of 1990 was that year's better half (the national recession started in July 1990), whereas the first half of 1991 likely will prove to be the weaker half. To compensate for this difference, the reported permits in the first seven months of 1991 were annualized using the ratio of national activity to provide a reasonable proxy of total 1991 construction of 950,000 single-family and 275,000 multifamily units. While these annualized regional figures are not a forecast for 1991, they are a reasonable way of comparing reported activity so far with previous years' activity. The annualized 1991 figures were compared with 1990 as well as with the year that represented that market's peak in construction between 1985 and 1989. The 1991 figures were also compared with the depth of the early 1980s recession. The best and worst of each category are presented in the tables. The tables show a number of variations among cities during the recent recession and the recovery thus far.

> **While this unevenness and uncertainty continues, the housing recovery that has already begun will manifest itself only tentatively and unevenly across regional markets.**

Single-family housing

The Riverside-San Bernardino MSA in California has suffered the greatest loss in construction in the country. On an annualized basis, 1991 construction in these two Southern California counties is down by 26,200 units from the 1988 peak construction year (See Table 1). However, the drop is from extraordinary heights: Construction in the Riverside-San Bernardino MSA surpassed construction activity in all but four states in 1988—an extraordinary record. Even after suffering a drop of more than 60 percent from the peak and 25 percent during the past year, the absolute number of single-family permits issued in the area is surpassed by only two other MSAs—Atlanta and Washington, D.C. The relative strong performance of Riverside-San Bernardino in the limit-

TABLE 2

Multifamily Permit Issuance in 1991 by Metropolitan Statistical Area Compared to Peak 1985-89 and Trough 1980-83 Issuance (In Thousands)

Metropolitan Areas Ranked by absolute change from 1985-89 peak year	1991 Multi-Family Permits	Rank Among 100 MSAs	Change From 1985–89 Peak Years: Number of Permits	Rank	% Change	Rank	Change From 1980–82 Recession Trough Years: Number of Permits	Rank
Top Ten								
Honolulu, HI	5.1	10	3.0	1	144	2	3.8	3
Houston, TX	5.7	6	2.7	2	91	3	−12.0	100
Gary-Hammond, IN	2.8	25	2.2	3	374	1	2.5	11
Cincinnati, OH-KY-IN	4.0	16	0.2	4	4	4	2.8	8
Madison, WI	1.6	36	0.1	5	4	5	1.1	21
Lake County, IL	1.0	42	−0.3	6	−25	7	0.9	24
Wichita, KS	0.3	75	−0.4	7	−56	22	−1.0	79
Rochester, NY	0.4	72	−0.4	8	−53	19	0.1	44
Scranton-Wilkes-Barre, PA	0.2	81	−0.5	9	−68	38	−0.2	57
Bridgeport-Milford, CT	0.4	69	−0.6	10	−61	29	−0.1	53
Bottom Ten								
Chicago, IL	3.9	17	−12.0	91	−75	54	−0.3	62
New York, NY	5.8	4	−13.9	92	−71	41	−0.4	64
Tampa-St. Petersburg-Clearwater, FL	4.6	12	−14.2	93	−75	55	−2.7	92
Fort Worth-Arlington, TX	0.1	89	−14.3	94	−99	97	−4.6	97
Atlanta, GA	1.4	37	−17.1	95	−93	82	−4.6	96
Riverside-San Bernardino, CA	4.3	15	−20.3	96	−83	61	1.9	13
San Diego, CA	4.4	13	−23.1	97	−84	64	0.7	27
Dallas, TX	3.0	22	−25.0	98	−89	75	−7.4	98
Phoenix, AZ	0.5	56	−27.2	99	−98	94	−9.9	99
Los Angeles-Long Beach, CA	13.1	1	−40.5	100	−76	56	3.2	4

ed housing market of 1991 is an encouraging sign for the market as a whole, but the extent of the decline suggests that full recovery in today or tomorrow's environment is unlikely.

Riverside-San Bernardino, Los Angeles and San Diego, which rank among the 10 MSAs with the greatest drops in housing permits from their peak year, typify the general slowdown in the California housing market. Each area has lost 40 percent or more of the construction activity it once had.

Almost the entire West Coast is suffering, to some extent, from the housing slowdown. For example, Seattle, Portland, Sacramento and Honolulu appear among the greatest losers between 1990 and 1991.

The West Coast, however, is stronger than the East Coast. Most of the other cities that have dropped by the greatest absolute number or percentage from the peak year are on the East Coast. The large housing markets in the Southeast—from Atlanta to Tampa—have fallen significantly behind peak construction years in terms of number of units. However, it is the large size of these markets that puts them among the big losers. Construction in Atlanta is down 23 percent from its peak, about midway down the pack. The smaller New England and New Jersey metropolitan areas—hot growth markets during the heyday of Wall Street—are among the biggest losers on a percentage bases. These include Jersey City which has had essentially zero construction this year.

The slowdown on the East Coast is not limited to the Northeast. Single-family construction in Norfolk, Virginia is off 8,700 units from the peak—100 units worse than the decline in Tampa. There still is a lot of construction activity in Atlanta, but even so, it is off 8,000 units from the market's peak year.

The positive side of the regional picture of single-family construction is the mixture of revival in the energy cities, recovery in the Farm Belt and improvements in some industrial cities. In most cases, the best-performing areas in 1991 are those that suffered early and severely during the 1980s. Annualized permits thus far this year in Houston are 3,800 more than during all of 1990. Because of the uniqueness of the Houston recession, the column headings in Table 1 are inappropriate. For most cities, construction declined to a trough around 1982 and rose to a peak between 1986 and 1989. In Houston, however, construction peaked in 1982 and reached a trough in 1986. However, construction in Houston has not recovered to pre-oil-crash days. Estimated 1991 permit issuance of 12,900 units is well below the 27,000 units built during 1982.

Tulsa—another Energy Belt city—makes the list of those markets showing the greatest improvement from previous years' construction with 2,600 more units than during the best year during 1986-89. Other high-ranking cities are in the Industrial Belt (Louisville, Indianapolis, Milwaukee and Columbus) or in the Farm Belt (Omaha). Las Vegas, a strong housing market for the past few years, has continued to build during 1991. However, the economy of Las Vegas is slowing. This is a bad sign for an explosive growth area and suggests problems such as those experienced in Phoenix.

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Multifamily units

The multifamily construction market has experienced a much more severe decline than the single-family market, especially in comparison to pre-tax-reform days. In recent months, national multifamily construction has been running at rates of less than 200,000 units a year. This is down more than 70 percent from the 669,000 units actually started in 1985. On a regional basis, an area will make the 10 "best" list by only having lost 35 percent of its peak-year construction (See Figure 2). Only five markets on the list of 100 largest metropolitan areas are issuing multifamily permits at a rate that will surpass the best years of 1986 to 1989. Three of those MSAs—Gary, Indiana, Houston and Honolulu—are up from essentially no construction between 1986 and 1989, while the other two are up less than 5 percent. One quarter of the cities listed show annualized 1991 multifamily permits off more than 90 percent from their peak year.

Among the worst-performing regional markets in 1991 are the large apartment markets that reflect this overall trend. The extent of the decline in these markets cannot be overestimated. In Baton Rouge, Fort Worth, San Antonio, Oklahoma City and Tucson, annualized 1991 multifamily permits are down 99 percent from the peak year. In Los Angeles, apartment permit issuance has fallen from 54,000 to 13,100, while permits in Phoenix have fallen from 27,000 to less than 500. In 10 cities alone, annualized multifamily permits issued thus far in 1991 represent a drop of more than 200,000 units.

The slide is spreading even to those areas where growth had remained rapid well beyond the national peak. Apartment construction in Seattle is down by more than 10,000 units to 5,500 since 1990. This reflects the limited construction around Boeing factories, where employment growth has stopped.

Apartment construction in the next few years will consist of opportunistic developments and limited construction to meet natural demand growth. Construction of multifamily units for condominium ownership will remain weak except for those units that appeal to people who consciously choose to own something other than a house. Although we will continue to see gradual improvement in apartment operating figures, such as vacancy rates and rental increases, these positive signs will not translate into significant construction. New development will await a significantly looser financing climate and a weaker memory of the current commercial real estate crisis.

At this stage the economic recovery is both early and uncertain. Many industries and markets are still in a recession, while others await more positive news before engaging in significant new investment. All this is occurring in an era of upheaval for real estate and for certain housing finance providers, be they savings and loans, banks, insurance companies or Wall Street firms. While this unevenness and uncertainty continues, the housing recovery that has already begun will manifest itself only tentatively and unevenly across regional markets. **MB**

Robert Hopkins is a vice president in Salomon Brother's Real Estate Research Department. His fields of research include demographics, regional economics and commercial and residential real estate market trends.

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THE FHA FACTS

A detailed look at FHA insurance and claims data reveals much about the health of recent years' originations.

Brian Chappelle

Statistics recently made available by the Department of Housing and Urban Development on the performance of its FHA-insured portfolio reveal some encouraging signs for the mortgage lending industry. This article portrays some of the prominent results from the HUD study of FHA insurance and claims data, which covers the performance of Section 203(b) 30-year term mortgages originated from 1970 to 1991 as of June 30, 1991. From this data, several salient points can be observed:

- More than two-thirds of FHA's portfolio was originated in 1986 or later. Only 19 percent of the loans originated in the 1970s remain on FHA books.
- Loans originated in the 1986-to-1988 period are performing 100 percent better than the 1980-to-1985 books of business over similar periods of time and have claim rates comparable to the 1970s' books of business.
- To no one's surprise, FHA claims have been concentrated in the "oil-patch" states during the 1980s. Forty-eight percent of the claims HUD has paid on loans originated in fiscal years 1985 to 1986 came from Texas, Oklahoma, Louisiana, Colorado and Alaska. Fifty percent of all FHA loans originated in the state of Alaska in the first half of the 1980s have already resulted in claims for FHA.

Now we can observe the various ways this data breaks down and what impact it holds for the mortgage lending industry.

> **There is now growing concern that the FHA reforms have gone too far.**

Performance of recent business

During the 1980s, FHA experienced a tremendous increase in activity. FHA insured 4.2 million mortgages from 1986 to 1990—more than it did in the previous 13 years from 1973 to 1985. It is not surprising, therefore, that of FHA's insurance written since 1970 that is still in force, 71 percent, representing 3,278,359 insured loans, was originated in 1986 or later. Table 1 provides specific data broken down into four-year origination periods on the seasoning of FHA's portfolio as of June 1991.

FHA's future solvency will be dependent on the performance of FHA origination activity since 1986. While it is desirable to have a more-seasoned portfolio from a risk management perspective, the concern about the concentration of recent originations is abated by the fact that FHA has tightened its underwriting policies since 1986 with over 30 different measures (e.g., buydown restrictions, elimination of risky programs and stricter compensating factors for borrowers above credit ratio guidelines) to reduce credit risk. In addition, many of the loans originated in the last half of 1986 and much of 1987 are refinances of loans originated in earlier years.

Claim performance improving

Chart 1 compares the cumulative claim rates for FHA loans originated from 1970 to 1988 for the first three policy years. The chart documents the rise in claim rates for loans originated in the early 1980s. Claim rates for loans originated in 1986 to 1988 are lower and, in fact, are comparable to the levels of claim rates in the 1970s. Accordingly, while FHA's portfolio is unseasoned, the improved performance of recent originations is very encouraging.

In trying to pinpoint the causes of this performance over the last 20 years, Chart 2 shows a direct correlation between HUD's cumulative claim rates by year of insurance endorsement and interest rate movements. (There is a lag of several months, typically, between loan closing and insurance endorsement.) As mortgage interest rates rise, claim rates on mortgages originated in that particular time period rise similarly. While not available in this data, this relationship exists when there are changes within individual years. For example, when interest rates dropped sharply in the first half of 1986, FHA's claim rate on loans originated in the last half of 1986 was much lower than the claim rate on loans originated earlier that year. Also illustrative of this pattern is the tremendous peak in 1981, when FHA/VA interest rates were stretching to the 17 percent mark, and claim rates hit an all-time high of 8.1 percent for 1981 originations.

CHART 1

FHA Claim Rates for First Three Policy Years

1970-1988

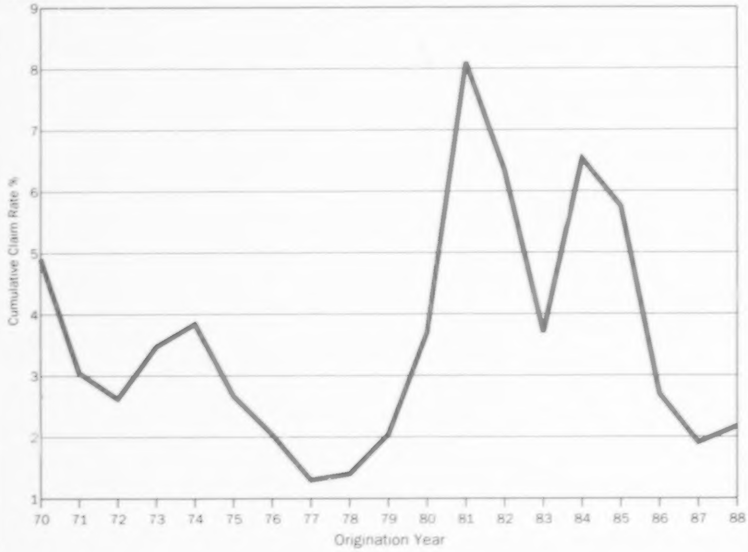
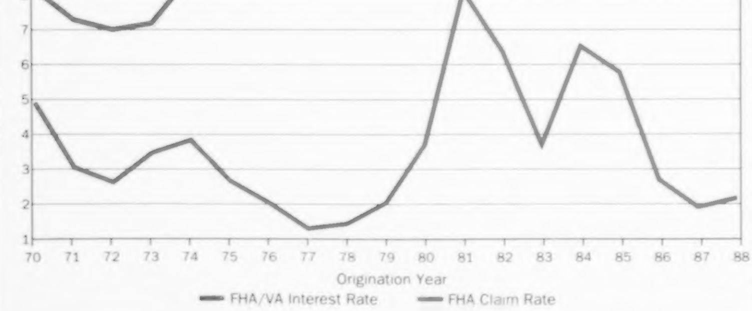


CHART 2

Interest Rate and FHA Claim Rate

For Period 1970-1988



Policy-year peaks

Chart 3 shows the number of claims that occurred by policy year for mortgages originated from 1981 to 1986. The increase in the number of claims for loans originated since 1983 stands out. This increase is tied to the growth in FHA activity that began in 1983 and continued steadily throughout the next several years.

Claims generally peaked in the third through fifth policy years and then declined in later years. Interestingly however, the 1979 and 1980 books of business are the exceptions to this rule. Chart 4 shows that in both years, there was a "second peak" for claims in the ninth policy year for 1979 originations and in the eighth policy year for 1980 originations. It is significant that 1987 was the year that both of these "second peaks" occurred.

Chart 5 provides claims by calendar year for loans originated from 1981 through 1986. In addition to the second peak for 1979 and 1980 origination years, the claims for the 1983 to 1985 books of business peaked in 1987. 1987 is also clearly a significant claim year for loans originated prior to 1980, as these loans also had a "second peak" in 1987.

Accordingly, it appears that the conditions existing in 1987, namely the re-

TABLE 1

Seasoning of FHA's Portfolio (Insurance-In-Force as of June 1991)

Years of Origination	Mortgages Outstanding	Percent Of Total
1971-75	315,593	7
1976-80	602,930	13
1981-85	410,316	9
1986-90	3,278,359	71

gional recession/depression in the Southwest, may have been the cause for the upturn in claims on these seasoned loans. These 1987 peaks appear, in fact, to be an anomaly, rather than evidence of a new trend whereby a second wave of risk would be expected to occur in later policy years. Based on the FHA data, it appears that the third through fifth policy years have the greatest credit risk.

> **FHA is, therefore, in effect becoming the insurer of last resort. Applications for FHA insurance have dropped 28 percent from April to August 1991.**

The occurrence of these second peaks in 1987, for seasoned loans that were at least 7 years old and may be as much as 17 years old, also indicates that whatever problems existed in 1987 had little, if anything, to do with the mortgage origination process. For a borrower to make mortgage payments for seven years or more before going into default is indicative of structural problems in the local economy rather than problems with the mortgage lending process.

Geographic analysis

There has been considerable discussion in recent years about the impact of location on the occurrence of claims. There is little doubt that regional economic conditions contributed greatly to the second peaks of claim years for many FHA-insured loans in 1987. In this section, claim rates by state are analyzed for FHA's 1972-to-1988 books of business.

To begin this analysis, five states with the most serious claim problems for three different endorsement years were analyzed to provide a perspective on the impact of the location of claims on FHA's overall claim performance. 1977 had the lowest annual claim rate; 1981 had the highest annual claim rate and 1986 had the most claims paid.

Table 2 provides the claim rates of states with the most serious problems for that book of business in 1977, 1981 and 1986. Each year shown in the table is noteworthy for significant feature. The 1977 list is represented predominantly by "Rust Belt" states. The 1981 list demonstrates the impact of the 1981-1982 recession on the Northwest and the beginning of the problems in

CHART 3

FHA 203(b) Claims Paid
by Policy Year (1981-86 Originations)

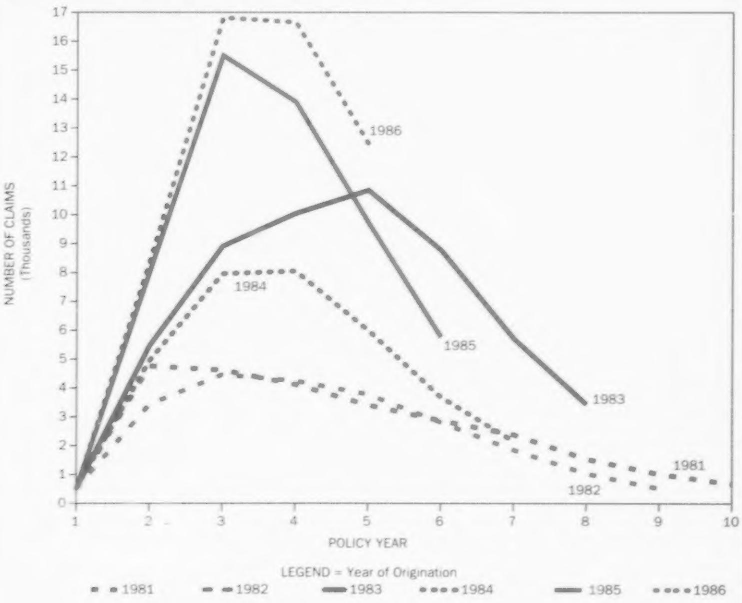
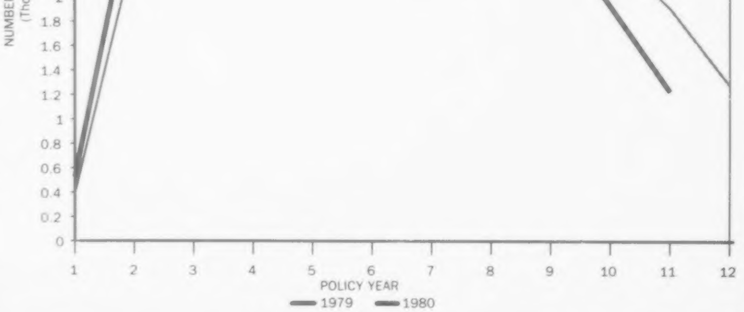


CHART 4

FHA 203(b) Claims Paid
By Policy Year (1979-1980 Origination)



the Southwest. The 1986 list shows the effect of the decline of states with oil-based economies.

What makes the 1986 data so devastating for FHA is the percentage of all of its claims that came from these five oil-patch states. Texas, Oklahoma, Louisiana, Colorado and Alaska comprised 19 percent of FHA's origination business and 48 percent of its claims during 1986. In the other three analyzed years, the percentage of all FHA claims that came from the five high-claim states was between 20 and 30 percent.

The impact of the problems in the oil-patch region is demonstrated in Chart 6. Throughout the entire period (1972 to 1988), the market share of the three states in the Southwest tied to the oil industry (Texas, Oklahoma and Louisiana) was between 12 and 18 percent of FHA's origination activity. Starting in 1978, there has been a steady increase in the percentage of FHA claims generated from these three states. The percentage peaked in 1986 when approximately one-third of all FHA claims on loans originated in 1986 came from these states.

The concentration is even more pronounced when the Houston area is analyzed separately. There are six field offices in Texas with Houston covering much of eastern Texas, and as much as 12 percent of all FHA claims on one year's book of business (1982) for the entire country came out of the Houston office.

The Denver office, which covers the entire state of Colorado, provides a similar picture for later years in the 1980s. As late as 1981, the Denver of-

CHART 5

FHA 203(b) Claims

By Calendar Year of Claim

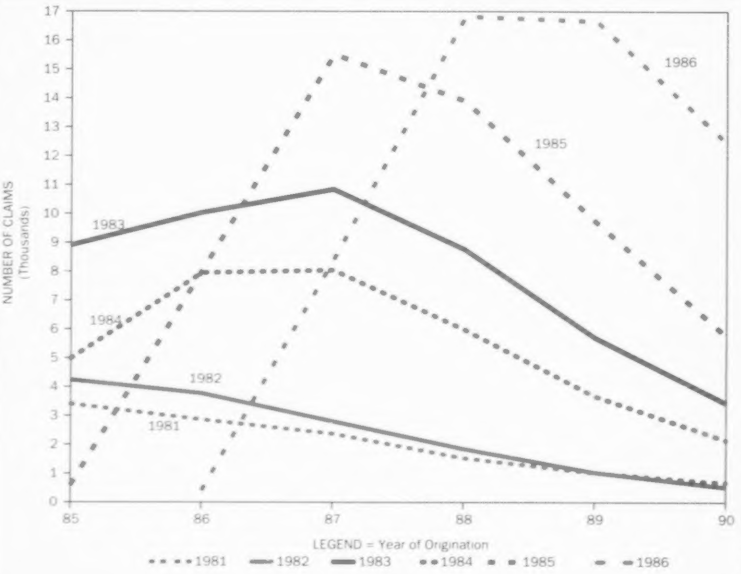
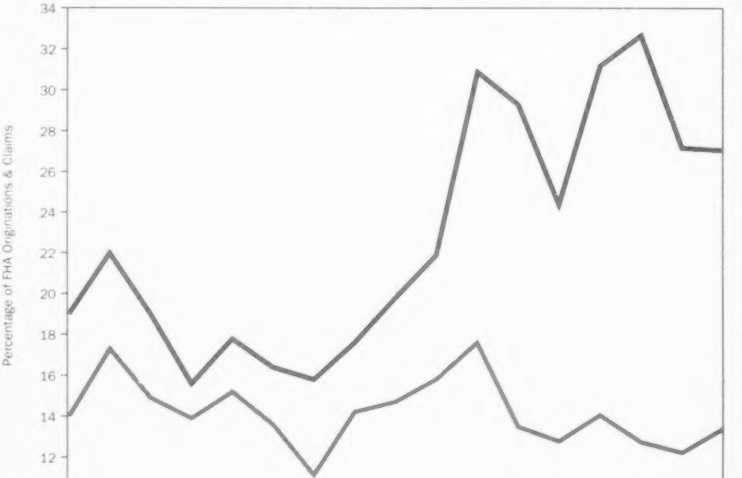


CHART 6

Percentage of FHA U.S. Total Insurance Written and Claims by Origination Year for Texas, Oklahoma & Louisiana

1972-1988



The Price Waterhouse Turnaround

In the fiscal year 1989 audit, the accounting firm of Price Waterhouse made an adjustment to FHA's financial statement to slow down the earning of premium revenue to cover possible increases in defaults. The company explained its position as follows:

> This change results principally from applying more conservative assumptions with respect to house price appreciation, and thus provides a better method of matching premium revenues to losses from single-family loans.

Instead of earning revenue in the early years (policy years two through five), Price Waterhouse believes that HUD needs to defer income to cover possible defaults in the future.

On March 8, 1989, Price Waterhouse had stated in a GAO report that HUD was not recognizing premium income fast enough. In one year, Price Waterhouse shifted its position 180 degrees.

fice had a lower claim rate than the national average. By 1986, however, just about one of every seven FHA claims that resulted from a loan originated during that year came from Colorado.

During the 1980s, FHA claims were increasingly concentrated in those states relying heavily on the oil industry. This data documents the impact of the economic devastation on the housing industry. While loan-to-value (LTV) data was unavailable, it has shown in the past that low LTV loans were not exempted from this problem. In fact, for 1985 and 1986 originations, LTVs below 80 percent in the five oil states had higher claim rates than LTVs above 95 percent in the rest of the country.

FHA released its fiscal-year 1990 financial statement, and it included positive signs that FHA's single-family program has turned the corner and is now in the midst of a complete recovery from the problems that plagued its operation in the 1980s.

This data may also explain the second peaks that occurred on seasoned loans. While data on claims by policy years is not available on a per-state basis, the economic problems and resulting property depreciation that beset the oil-patch states may be a significant factor in the number of seasoned loans that went into foreclosure during the period from 1985 to 1987.

What does this data mean for FHA's financial condition?

Last month, FHA released its fiscal-year 1990 financial statement, and it included positive signs that FHA's single-family program has turned the corner and is now in the midst of a complete recovery from the problems that plagued its operation in the 1980s. For the first time since 1987, the Mutual Mortgage Insurance Fund (MMIF), out of which the basic single-family program is operated, generated a net income of $66 million from its insurance operations. HUD acknowledged in the financial summary that this improvement was the result of a decline in single-family defaults and claims.

What is even more encouraging is that this improvement occurred even though an accounting adjustment made by Price Waterhouse in its 1989 audit, which slowed down the earning of income, remained in effect (See sidebar). As a result of that adjustment, even though FHA collected approximately $400 million more in premiums in fiscal year 1990 than it did in 1988 before the adjustment went into effect, it earned $325 million less in total income.

The impact of this change is seen in the growth of the unearned premium account, which has risen from $3.8 billion in fiscal year 1988 to $5.6 billion in fiscal year 1990. This $1.8 billion nest egg is, in effect, a deferred compensation plan for the FHA program.

Another indication of FHA's improving financial strength is that there was a $638 million increase in "net cash operations." In fiscal year 1989 there had been only a $44 million increase and in fiscal year 1988 there had been a $322 million decrease in cash operations. The major items of the cash-flow statement are total premiums collected plus proceeds from the disposition of HUD properties minus claim settlement payments, premiums earned and the decline in loss reserves.

It is this last item that gives yet an-

TABLE 2

1977 Book of Business
High Claim Rates

State	Claims	Mortgages	Claim Rate
Pennsylvania	266	1,970	13.5
Illinois	301	2,300	13.1
Indiana	471	4,354	10.8
Ohio	1,024	9,840	10.4
Michigan	308	3,209	9.6
5 State Total	2,370	21,673	10.9
Rest of U.S.	7,148	220,860	3.2
U.S. Total	9,518	242,533	3.9
5 States As % of U.S. Total	25%	9%	

1981 Book of Business
High Claim Rates

State	Claims	Mortgages	Claim Rate
Oregon	409	966	42.3
Oklahoma	549	1,586	34.6
Illinois	1,345	4,054	33.2
Texas	4,672	16,256	28.7
Washington	862	3,084	27.9
5 State Total	7,837	25,937	30.2
Rest of U.S.	18,300	98,121	18.6
U.S. Total	26,137	124,058	21.1
5 States As % of U.S. Total	30%	21%	

1986 Book of Business
High Claim Rates

State	Claims	Mortgages	Claim Rate
Alaska	1,374	4,605	29.8
Texas	12,694	88,334	14.3
Oklahoma	3,761	18,059	20.8
Louisiana	1,893	15,077	12.6
Colorado	7,404	58,220	12.7
5 State Total	27,126	184,295	14.7
Rest of U.S.	28,899	763,672	3.7
U.S. Total	56,027	947,967	5.9
5 States As % of U.S. Total	48%	19%	

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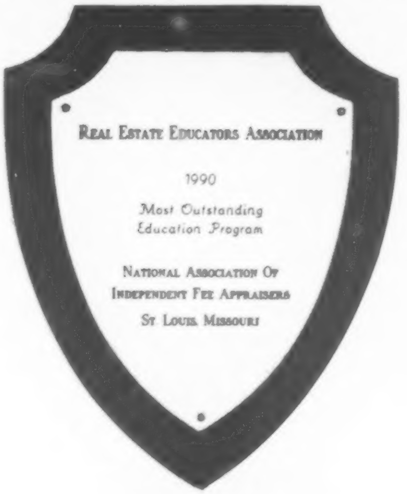

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other piece of good news from the fiscal year 1990 audit. Loan loss reserves were lowered $219.8 million in the fiscal year 1990 audit. This is the second straight year that FHA loss reserves were lowered. Because Price Waterhouse increased loan loss reserves by $1.2 billion in fiscal year 1988 there has now been a 58 percent ($694 million) decline from that figure.

The next chapter

It would have been nice to conclude this article by stating that FHA is on the road to complete recovery. As the saying goes, however, there is another chapter of this story yet to be written.

While HUD moved quickly to correct the abuses that occurred under Secretary Samuel Pierce with the enactment of the HUD Reform Act of 1989 and the implementation of numerous management improvements, there is now growing concern that the FHA reforms have gone too far. Specifically this pertains to the provisions of the 1990 housing bill that raise down payments and increase mortgage insurance premium costs for homebuyers. It is the latter point that raises questions about FHA's future solvency.

With the implementation of a one-half percent annual premium in addition to the 3.8 percent upfront MIP on loans closed July 1, 1991, HUD has increased the likelihood of adverse selection in the FHA program. Because of the increase cost, lower risk borrowers who were the backbone of the FHA program are now opting for private mortgage insurance because of lower cost and less red tape. FHA is, therefore, in effect becoming the insurer of last resort.

While definitive conclusions can not be reached for several more months, the initial returns are alarming. Applications for FHA insurance have dropped 28 percent from April to August 1991.

Based on the improvements discussed in this article, it is ironic that it now appears that FHA faces greater risk to its future solvency from the implementation of measures developed in the spirit of reform than it does from the performance of FHA's existing portfolio. **MB**

Brian Chappelle is staff vice president of residential finance and government agency relations at the Mortgage Bankers Association of America in Washington, D.C.

VITAL STATISTICS

KEY ECONOMIC INDICATORS AND INTEREST RATES

	CHANGES IN PAYROLL EMPLOYMENT (THOUSANDS)	UNEMPLOYMENT RATE (%)	CHANGES IN CONSUMER PRICES FROM YEAR AGO LEVELS (%)		MORTGAGE INTEREST RATES (%)		
					SECONDARY MARKET YIELD ON FHA NEW HOME MORTGAGES[1]	FHLMC	
			ALL ITEMS	ALL ITEMS LESS FOOD AND ENERGY		ARMs	FRMs
AUG-90	−109	5.6	5.6	5.5	10.20	8.35	10.10
SEP-90	−47	5.7	6.2	5.5	10.26	8.28	10.18
OCT-90	−131	5.7	6.3	5.3	10.24	8.21	10.18
NOV-90	−221	5.9	6.3	5.3	10.02	8.10	10.01
DEC-90	−140	6.1	6.1	5.2	9.74	7.93	9.67
JAN-91	−203	6.2	5.7	5.6	9.62	7.74	9.64
FEB-91	−258	6.5	5.3	5.6	9.58	7.65	9.37
MAR-91	−258	6.8	4.9	5.2	9.59	7.47	9.50
APR-91	−166	6.6	4.9	5.1	9.61	7.38	9.49
MAY-91	151	6.9	5.0	5.1	9.62	7.22	9.47
JUN-91	−21	7.0	4.7	5.0	9.67	7.24	9.62
JUL-91	−51	6.8	4.4	4.8	9.65	7.23	9.58
Aug-91	NA	NA	NA	NA	NA	7.08	9.24

RATES ON SELECTED SECURITIES (%)

	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT				A-Rated Utility
			6-Month	1-Year	3-Year	10-Year	
AUG-90	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP-90	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT-90	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV-90	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC-90	7.31	7.80	6.70	7.05	7.47	8.08	9.95
JAN-91	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB-91	6.25	6.49	5.93	6.27	7.08	7.85	9.54
MAR-91	6.12	6.41	5.92	6.40	7.35	8.11	9.58
APR-91	5.91	6.07	5.71	6.24	7.23	8.04	9.46
MAY-91	5.78	5.92	5.61	6.13	7.12	8.07	9.45
JUN-91	5.90	6.11	5.75	6.36	7.39	8.28	9.53
JUL-91	5.82	6.05	5.70	6.31	7.38	8.27	9.55
AUG-91	5.66	5.72	5.39	5.78	6.80	7.90	9.25

CURRENT SECONDARY MARKET YIELDS (%)

	GNMA[2]	FNMA[2]	FHLMC[2]
AUG-90	9.80	9.75	9.75
SEP-90	9.86	9.79	9.73
OCT-90	9.84	9.80	9.69
NOV-90	9.63	9.66	9.54
DEC-90	9.22	9.27	9.16
JAN-91	9.17	9.24	9.12
FEB-91	8.81	8.86	8.77
MAR-91	9.00	9.03	8.93
APR-91	8.95	8.98	8.88
MAY-91	8.94	8.95	8.86
JUN-91	9.16	9.18	9.06
JUL-91	9.14	9.17	9.06
AUG-91	8.70	8.75	8.65

SPREADS
(Basis Points)

	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
AUG-90	105	100	100
SEP-90	97	90	84
OCT-90	112	108	97
NOV-90	124	127	115
DEC-90	114	119	108
JAN-91	108	115	103
FEB-91	96	101	92
MAR-91	89	92	82
APR-91	91	94	84
MAY-91	87	88	79
JUN-91	88	90	78
JUL-91	87	90	79
AUG-91	80	85	75

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Millions of Dollars)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies
AUG-90	41,054	14,948	12,940	12,710	34	2,629	100	950	1,296	92	20,513	1,258	650	15,178	2,994
SEP-90	36,091	13,871	10,616	11,174	36	1,705	177	854	307	112	17,676	25	576	13,623	3,343
OCT-90	36,570	12,834	11,324	12,013	37	1,965	207	840	689	28	14,120	0	551	10,327	3,041
NOV-90	32,958	13,104	8,750	10,716	43	2,157	211	669	970	122	16,557	0	580	12,618	3,288
DEC-90	29,339	11,380	8,500	9,089	39	2,904	184	760	1,360	349	19,156	0	703	13,695	3,705
JAN-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
FEB-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
AUG-90	1,131	865	266	1,055	817	238	122	240	434	335	114	221	405	315
SEP-90	1,106	893	213	989	778	211	104	239	445	318	111	218	385	275
OCT-90	1,026	861	165	925	747	178	144	230	392	260	114	194	360	257
NOV-90	1,130	823	307	916	710	206	147	232	483	268	108	194	366	248
DEC-90	971	768	203	854	689	165	110	233	395	233	99	181	338	236
JAN-91	847	677	170	802	651	151	86	167	361	233	96	188	306	212
FEB-91	992	825	167	876	739	137	91	301	384	216	99	205	353	219
MAR-91	907	770	137	892	734	158	104	226	390	187	96	204	340	252
APR-91	977	833	144	913	787	126	93	236	395	253	102	210	361	240
MAY-91	983	867	116	966	801	165	114	216	367	286	105	221	379	261
JUN-91	1,032	888	144	999	834	165	145	246	389	252	115	227	391	266
JUL-91	1,070	942	128	1,005	836	169	106	235	448	281	116	235	400	254
AUG-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOME SALES

(Units and Prices in Thousands)

	EXISTING HOMES		NEW HOMES		
	Sold (SAAR)	Median Sales Price (Dollars)	Sold (SAAR)	Median Sales Price (Dollars)	Months Supply At Current Sales Rate
AUG-90	3,410	97.2	525	118.4	8.1
SEP-90	3,160	94.4	504	113.0	8.4
OCT-90	3,070	92.9	465	120.0	8.7
NOV-90	3,150	92.0	480	118.9	8.2
DEC-90	3,130	91.7	464	127.0	8.4
JAN-91	2,900	95.6	414	117.9	9.3
FEB-91	3,160	94.0	488	119.9	8.0
MAR-91	3,220	98.2	495	122.5	7.5
APR-91	3,310	100.3	506	121.0	7.3
MAY-91	3,540	101.1	496	118.0	7.4
JUN-91	3,590	102.0	516	120.1	7.1
JUL-91	3,350	103.0	472	120.2	7.6
AUG-91	NA	NA	NA	NA	NA

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

	Total[6]	1-Unit	2+ Units	Nonresidential
AUG-90	301.3	95.3	17.4	106.6
SEP-90	296.7	92.8	16.9	105.6
OCT-90	291.3	90.9	16.7	102.6
NOV-90	285.2	88.0	16.1	100.0
DEC-90	280.6	85.7	15.9	98.5
JAN-91	274.1	81.8	16.3	95.0
FEB-91	270.9	78.6	15.6	96.1
MAR-91	264.5	76.3	15.4	93.3
APR-91	267.9	76.4	14.4	97.5
MAY-91	261.1	79.9	13.9	88.6
JUN-91	260.1	83.4	13.4	83.9
JUL-91	262.5	87.2	12.5	83.8
AUG-91	NA	NA	NA	NA

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Securities for 0- to 30-day delivery.

[3] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[4] Savings & Loans and Mutual Savings Banks.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.